No. 13608

In the United States Court of Appeals for the Ninth Circuit

THE JOHN DANZ CHARITABLE TRUST, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

H. BRIAN HOLLAND,
Assistant Attorney General.
ELLIS N. SLACK,
MELVA M. GRANEY,
Special Assistants to the Attorney General.

INDEX

CITATIONS

Cases:

Cases—Continued

Statutes:

Miscellaneous:

In the United States Court of Appeals for the Ninth Circuit

No. 13608

THE JOHN DANZ CHARITABLE TRUST, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 106-129) are reported at 18 T.C. 454.

JURISDICTION

The Commissioner determined deficiencies in income tax, declared value excess profits tax, and excess profits taxes against taxpayer for the years 1943 to 1947, inclusive, and added a penalty addition for the year 1947. (R. 108.) Notice of the deficiencies for the years 1943, 1944 and 1945 was mailed to taxpayer on October 14, 1949 (R. 10-23), and for the years 1946 to 1947 on

March 5, 1951 (R. 54-60). Petition for review by the Tax Court as to the 1943, 1944 and 1945 deficiencies (R. 3-40) was filed on January 9, 1950 (R. 40). Petition for review by the Tax Court as to the 1946 and 1947 deficiencies (R. 47-78) was filed April 9, 1951 (R. 78). Accordingly, both petitions were filed within the 90-day period allowed by Section 272 of the Internal Revenue Code. The petition covering the years 1943, 1944 and 1945 was subsequently amended (R. 44-45) and the Commissioner filed an answer to it both before and after amendment (R. 40-43, 46-47). The Commissioner filed an answer to the petition covering the years 1946 and 1947 (R. 78-81) and both cases were consolidated in the Tax Court with other cases involving individual taxpayers (R. 106). After hearing in the consolidated cases, the Tax Court entered decision in each of the instant cases on August 19, 1952, determining deficiencies in income tax in the total amount of $165,667.47 and a penalty of $797.47 for 1947. (R. 130-131.) A petition for review by this Court in each case was filed on September 11, 1952 (R. 131-133, 134-135), and the two cases were subsequently consolidated for hearing and decision in this Court (R. 145). The Court accordingly has jurisdiction of the cases under Section 1141 (a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTIONS PRESENTED

1. Whether the trust, which was authorized to and did conduct businesses for profit, was "organized and operated exclusively for * * * charitable * * * purposes", and is thus exempt from tax under Section 101 (6) of the Internal Revenue Code, simply because the trust fund is payable only to such exempt organizations

as John Danz, one of the grantors, shall designate from time to time during his lifetime and, upon his death, by his will.

2. Whether the trust net income of the taxable years not actually paid to charitable organizations during the taxable years was, pursuant to the trust instrument, "permanently set aside" for charitable purposes during the taxable years, and is thus deductible under Section 162 (a) of the Code, even though the income was subject to use by the trustees for speculative investments and for the purchase and operation of trades and businesses, and charitable organizations could receive only such trust funds as John Danz designated during his lifetime (for which deduction has been allowed) and which remained at his death.

3. Whether the filing by taxpayer of Form 990 returns required of exempt organizations under Section 54 (f) of the Code started the running of the three-year limitation period prescribed by Section 275 (a) for assessment of taxes so as to bar collection of the income tax deficiencies for 1943, 1944 and 1945.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and Treasury Regulations are set forth in the Appendix, *infra*.

STATEMENT

The facts found by the Tax Court pertinent to the issues on appeal are as follows:[1]

On December 31, 1942, John Danz and his wife Jessie created "The John Danz Charitable Trust" (see R. 23-25) to which they transferred 900 shares of Sterling

[1] All facts stipulated by the parties (R. 81-105) were incorporated by reference in the Tax Court's findings (R. 118).

Theatres, Inc., common stock. The trustees named were John Danz and the grantors' two sons, William and Frederic Danz. (R. 109-110.)

John Danz, who had been in the business of operating motion picture theatres in Seattle for about 40 years, concluded during the latter part of World War II that different ideologies were causing a great deal of trouble and even had a tendency to create wars; that the country was about ready for some philosophy with some common ground acceptable to everyone based upon science, pragmatism, experience and research that would eliminate all differences of opinion; but that to get such an organization started in a large number of communities would require money. It was for making and supplying money for such a purpose that "The John Danz Charitable Trust" was created. John hoped to find some organization in the United States with a number of branches which could be helped with the trust funds to grow and educate the people. He did not know of any such organization at the time he created the trust and for that reason reserved in the trust the right to designate the charitable beneficiaries of the trust. (R. 109-110.)

The trustees were given broad powers over the trust property, including the power to engage in business under various forms, to loan funds of the trust with or without security, to join in enterprises in which the trustees were personally interested provided they exercised good faith in the interests of the trust estate, and, in investing or speculating, to combine funds of any trusts created by the grantors. The trustees were entitled to receive reasonable compensation for their services but received none during the taxable years.

They were not to be personally liable, in the absence of bad faith, for any losses from proper use of the trust funds. The grantors were not to derive and they have not derived, directly or indirectly, any benefit from the trust property. The trust was irrevocable but could be amended in certain respects by the joint action of William Danz, Fred Danz and Leslie Stusser (the latter of whom was not related to or employed by any of the Danzes). The power to amend did not include the power to change the beneficiaries or to make a change which would in any way benefit the grantors or their estates. Additional property could be added to the trust. Leslie Stusser was to take the place of John Danz as trustee if occasion arose. Any other vacancy was to be filled by appointment made by the remaining trustees. The trustees were to act through a majority. The trust instrument was to be governed by the laws of Washington. (R. 110-112.)

Under the trust instrument John Danz was to have the right during his lifetime and by his will to designate the beneficiary or beneficiaries of the trust and to change, add, or withdraw beneficiaries which were to receive corpus or income of the trust at times and in amounts specified by him. Designations were to be in writing delivered to the trustees. Only a corporation or organization "of a type which is within the exemption from Federal Income Tax now granted by Paragraph 101 of the Internal Revenue Code and in the event such exemption is hereafter restricted, then also within such restrictions" could be designated and the beneficiary also had to be of the type then specified in Sections 23 (o), 812 (d), and 1004 (a)(2) of the Internal Revenue Code so that the contribution, bequest or gift to

such beneficiary would be deductible from income and exempt from estate and gift tax and in the event those classes were further restricted, then the beneficiary had to be within such restrictions. Named adult grandchildren or the trustees were to make similar designations covering any amount remaining in the trust after John's death and not covered by his will. (R. 111.)

No amendments were made in the trust during the taxable years.[2] John, William and Frederic Danz served as trustees of the trust from its inception throughout the taxable years.[3] Books and records were kept for the trust. Title to all of the assets of the trust has been taken in the name of the trustees. Bank accounts were maintained for the trust. (R. 112.)

During the taxable years additional contributions to the trust were made in cash, in stock of Sterling Theatres, Inc., and in stock of Sterling Theatres Company, Inc., by the grantors, and by William Danz and his wife and Frederic Danz and his wife. The total contributions during the taxable years amounted to $109,542. (R. 112).

John Danz, after the creation of the trust, continued, at his own expense, to search for the type of organization which he had in mind in forming the trust, and after several years of travel and search he decided that there were groups of Humanists which came close to what he had in mind. He was instrumental with others in starting such an organization in Seattle beginning in the early part of 1947. It was incorporated as the Humanist Society of Washington. Prior thereto and

---

[2] Amendments were, however, made in 1948 and 1949. (R. 87-88.)

[3] In 1949, after the taxable years, the Seattle Trust and Savings Bank was added as a trustee. (R. 88.)

beginning in September of 1946, he had designated "American Humanist Society", an organization which had a number of affiliates in different parts of the United States, as a beneficiary to receive funds of the trust in the total amount of $11,500. He was also instrumental, along with others, in starting the Humanist Society of San Francisco and, after the taxable years, in starting the Humanist Society of Los Angeles. The first distribution from the trust to the Humanist Society of Washington was made on March 20, 1947. Thereafter during that year additional large distributions were made to the Humanist Society of San Francisco and to other charitable organizations. (R. 113.)

The trust purchased 600 shares of stock of Midland Steel Products for $17,691.64 in 1943 and sold those shares for a profit of $4,583.62 in 1945. It bought and retained 500 shares of Anaconda Copper in 1945 and 1,500 shares in 1946, and, in 1946, 1,000 shares each of Boeing Airplane Company, National Gypsum, and Westinghouse Electric at a total cost of $161,154.25. It also held on December 31, 1947, donated shares of Sterling Theatres, Inc., and Sterling Theatres Company, Inc., which it carried at $56,992. (R. 113-114.)

The trust made the following purchases (R. 114):

	Cost	Year
Savoy Hotel Property, including furnishings and fixtures	$166,440.76	1943
Improved real estate Seventh and Pike	95,544.23	1943
Improved real estate Eighth and Pike	42,866.11	1943
Improved real estate Sixth and University	75,104.70	1946
Improved real estate San Francisco	42,882.35	1947

That trust held the properties during the remaining taxable years and received rents therefrom, except that it sold the property at Eighth and Pike in 1946 at a

profit of $43,740.78. The Savoy Hotel property and the Seventh and Pike properties substantially increased in value during the taxable years. There was a mortgage on the Savoy Hotel building in the amount of about $68,000 at the end of 1943. It was reduced $21,676 during 1944, but by the end of 1945 it had been increased to about $91,000. Thereafter, it was gradually reduced until it amounted to $45,739.74 at the end of 1947. There was a mortgage on the Seventh and Pike property which amounted to $44,860.04 at the end of 1943. It had been reduced to $19,689.04 by the end of 1945 and was paid off in 1946. There was a mortgage on the Sixth and University property which amounted to $54,582.22 at the end of 1946. It had been reduced to about $45,000 at the end of 1947. (R. 114-115.)

The trust borrowed money from John Danz and from Sterling Theatres, Inc., at three per cent during the taxable years. John had to borrow money at interest rates in excess of three per cent to make the loans to the trust. The loans payable of the trust at the end of 1943 amounted to $138,321.06. They were about $4,000 less at the end of 1944 and amounted to about $1,800 at the end of 1945. They amounted to $109,000 at the end of 1946 and to $89,500 at the end of 1947. (R. 115.)

The trust purchased a retail candy shop on September 10, 1943, for $1,514.75, another on September 22, 1943, for $875, and a third on January 31, 1944, for $1,500. It operated each shop after the purchase throughout the taxable years but at some undisclosed time thereafter ceased operating them. Each candy shop was adjacent to a theatre owned or managed by

Sterling Theatres, Inc. Jessie Danz managed the three candy shops without pay because she wanted to make a contribution in that way to the acquisition of funds for the charitable trust. (R. 115.)

The net worth of the trust, as shown on its balance sheets, increased from $65,862.62 at the end of 1943 to $448,420.09 at the end of 1947. (R. 115.)

The average of the annual gross receipts from the Savoy Hotel for the taxable years was about $141,000, the operating expenses about $96,400, and the net income about $44,600. The trust had additional income from rentals during the taxable years ranging from $2,270 in 1943 to $12,564.50 in 1945. The total sales of the candy shops during the taxable years were $329,233.95, the net sales $158,689.10, expenses $106,435.75, and the net profits from the operation, including a small amount of income from telephones, were $52,650.44. Dividends received by the trust during the taxable years amounted to $23,458.10. The total net income of the trust for the taxable years, including profits on sales, was $404,526.29. (R. 115-116.)

The trust made no distributions in 1943. Thereafter, it made distributions to a number of organizations, exempt from tax under Section 101 of the Internal Revenue Code, of the types described in Sections 23 (o), 812 (d) and 1004 (a)(2). The total of those charitable contributions was $65,637.54, of which about two-thirds was contributed in 1947. (R. 116.)

The Humanist Society of Washington occupied a large portion of the Sixth and University building rent-free from the time of the inception of that organization. The trust received rent from some other space in that building. The building in San Francisco was occupied

rent-free by the Humanist Society of San Francisco. (R. 116.)

The intention of the trustees in purchasing the Savoy Hotel property was to operate it only until the personal property could be sold and the real property leased to a hotel operator. Efforts were made to find such a lessee but no satisfactory arrangement was made until January 1, 1948. The hotel, at the time it was purchased by the trust, was being operated by a real estate company in Seattle and that company continued to operate the property for the trust under an oral agreement during the taxable years and until January 1, 1948, when the furnishings were sold for $60,000 and the real estate was leased to a hotel operator. (R. 116-117.)

The trust made no loans to the grantors and no joint investments with anyone during the taxable years. (R. 117.)

On September 19, 1946, the trust filed with the Collector of Internal Revenue an exemption affidavit on Form 1023, together with returns on Form 990 for the calendar years 1943, 1944 and 1945 (Joint Exhibits 2B, 3C and 4D). On November 22, 1946, a letter was written to the trustees of the trust by the Acting Deputy Commissioner of Internal Revenue to the effect that the trust was not exempt and requiring the filing of income tax returns for the trust for all years. Reconsideration was thereafter requested and on July 3, 1947, the Commissioner of Internal Revenue wrote the trustees of the trust that upon reconsideration of the matter the previous conclusion was affirmed and that returns must be filed. On the same date the Collector, pursuant to the Commissioner's ruling, wrote demanding the filing

of income tax returns for the trust from the date the trust was created. The Form 990 return for the year 1946 (Joint Exhibit 5E) filed by the trust on May 9, 1947, was not accepted by the Commissioner. (R. 83-84.)

On July 28, 1947, income tax returns on Form 1041 were filed by the trust for the calendar years 1943, 1944, 1945 and 1946 (Joint Exhibits 6F, 7G, 8H and 9I). The returns were accompanied by a letter from trustee William Danz stating that the returns were being filed in accordance with the Collector's request but that the trustees did not agree that returns should be filed and believed that the trust was exempt from tax. A return on Form 1041 for the year 1947 (Joint Exhibit 10J) was not filed until May 6, 1948. (R. 84.)

In each of the returns on Form 1041 the trust showed the income and expenses, took deductions for contributions paid during the year, and took a deduction in the amount of the balance of the income of the trust claimed to constitute income which, pursuant to the terms of the trust agreement, was permanently set aside for exempt purposes under Section 162 (a) of the Code. (R. 84-85.)

On December 7, 1949, a consent was executed by the trust and the Commissioner extending the time for assessment of tax for 1946 to June 30, 1951. (R. 85.)

On October 14, 1949, the Commissioner mailed to the trust a notice of deficiency in taxes in the total amount of $136,944.45 for the years 1943, 1944 and 1945. On March 5, 1951, the Commissioner mailed to the trust a notice of deficiency in taxes for 1946 and 1947 in the total amount of $52,898.65, together with a penalty of $1,967.96 for 1947. (R. 85.)

On the issues appealed, the Tax Court held that the trust is not exempt from tax under Section 101 (6) of the Code (R. 118-120); that its income for the taxable years was not permanently set aside for charitable purposes so as to be deductible under Section 162 (a) (R. 123-125); and that collection of the deficiency taxes for 1943, 1944 and 1945 is not barred by the three-year statute of limitations by reason of the filing of Form 990 returns for those years on September 1, 1946 (R. 126-128).

SUMMARY OF ARGUMENT

1. The Tax Court held that taxpayer was not "organized and operated exclusively for * * * charitable * * * purposes" within the meaning of Section 101 (6) of the Internal Revenue Code and therefore is not exempt from tax. That holding is clearly correct, for two reasons. First, exemption must rest in the first instance upon a functional charitable activity and taxpayer was not organized or operated to engage in any functional charitable activity. Secondly, exemption is accorded only to such organizations engaged in a functional charitable activity as are "exclusively" so engaged and taxpayer was operated for the non-charitable purpose of conducting trades and businesses for profit. There is no merit in taxpayer's contention that exemption must be accorded to it simply because the trust fund is ultimately destined for such exempt organizations as John Danz designates.

Contrary to taxpayer's assertion, there is no long line of decisions applying ultimate destination as the sole test of exemption. *Roche's Beach, Inc.* v. *Commissioner*, 96 F. 2d 776 (C.A. 2d), the supposed originator of that theory, and *Willingham* v. *Home Oil Mill*, 181 F. 2d 9 (C.A. 5th), certiorari denied, 340 U. S. 852,

held only that a corporation which was an operating medium of an exempt organization was exempt. In effect, those decisions attributed the functional charitable activities of the parent to the subsidiary, as this Court appears also to have done in *Squire* v. *Students Book Corp.,* 191 F. 2d 1018. In the present case there is no basis for attributing any functional charitable activity to taxpayer. The recent decisions in *C. F. Mueller Co.* v. *Commissioner,* 190 F. 2d 120 (C.A. 3d), and *Sico Co.* v. *United States,* 102 F. Supp. 197 (C. Cls.), are the only decisions which may be said to support application of ultimate destination as the sole test of exemption. Those decisions are contrary to this Court's decision in *Bear Gulch Water Co.* v. *Commissioner,* 116 F. 2d 975, certiorari denied, 314 U. S. 652, and to *United States* v. *Community Services,* 189 F. 2d 421 (C.A. 4th), certiorari denied, 342 U. S. 932, and *Stanford University Book Store* v. *Helvering,* 83 F. 2d 710 (C.A.D.C.). See also, *Mabee Petroleum Corp.* v. *United States* (C.A. 5th), decided April 17, 1953 (1953 P-H, par. 72,474).

For a number of reasons it is clear that Section 101 (6) does not exempt a trust to which no functional charitable activity can even be attributed. The fact that the trust fund is ultimately destined only for exempt organizations means no more than that the trust fulfills the requirement of Section 101 (6) that no part of its net earnings inure to any private individual. Section 101 (6) also requires that the trust be "organized and operated exclusively for * * * charitable * * * purposes," which, unless meaningless, is a functional requirement. That Congress intended it as a functional requirement is evident from considera-

tion of subdivision (14) of Section 101, which alone relates to exemption on the basis of destination of income; Section 162 (a), which provides an unlimited deduction (as distinguished from exemption) by reason of the destination of trust income but restricts the deduction to amounts paid or permanently set aside during the taxable years for payment to charity; the legislative intent reflected in 1935 when the language of Section 101 (6) was adopted in Section 811 (b)(8) of the Social Security Act; and the legislative intent and understanding as reflected in the Revenue Act of 1950. By Section 301 of the 1950 Act Congress taxed the "unrelated business net income" of *exempt* organizations, defined as income from any trade or business not substantially related, aside from "the use it makes of the profits derived", to the exercise or performance of the charitable "purpose or function constituting the basis for its exemption under section 101". There is no excuse for not applying this clear reflection of the Congressional intent to Section 101 (6), for the section was not changed by the 1950 Act.

Taxpayer was not operated "exclusively" for charitable purposes, as required for exemption under Section 101 (6). Viewing its purposes most liberally and assuming that a functional charitable activity is unnecessary for exemption, it had two purposes—the conduct of business enterprises for profit and the contribution of the trust funds to charity—one of which was charitable and one not. Section 302 (a) of the 1950 Act provided that, for years prior to 1951, an organization is not to be denied exemption if its business income is substantially related to the exercise of its functional charitable activities—which clearly implies that exemption is to be denied in the converse

situation. That indeed was the implied Congressional intent from the consistent reenactment of Section 101 (6) despite long-standing Treasury Regulations to the effect that exemption is not even to be accorded a religious organization which also manufactures and sells articles to the public for profit. The decisions which have accorded exemption to an organization despite the fact that it was engaged in the operation of an unrelated trade or business, including *Roche's Beach*, are contrary to several decisions, including this Court's decision in *Bear Gulch Water Co.* and the Supreme Court's decision in *Trinidad* v. *Sagrada Orden,* 263 U. S. 578.

2. Section 162 (a) of the Code allows an unlimited deduction for any part of the trust income which, pursuant to the trust instrument creating the trust, was during the taxable years paid or permanently set aside for payment to exempt organizations or which is to be used directly by the trust for charitable purposes. None of the instant trust income was to be used directly by the trust for charitable purposes, for the trust was not organized or operated to engage in any functional charitable activity. The amounts of trust income actually paid out during the taxable years to exempt organizations pursuant to John Danz's designation have been allowed as deductions. Taxpayer is therefore entitled to additional deductions only for trust income which, pursuant to the trust instrument, was during the taxable years permanently set aside for payment to exempt organizations. As the Tax Court held, none of taxpayer's income was so permanently set aside.

The trustees did not permanently set aside any of the trust income during the taxable years and there is no

merit in taxpayer's contention that the trust instrument itself did. Aside from the trust income actually paid to exempt organizations during the taxable years, the trust instrument required only that the trust fund remaining at John Danz's death be paid to such exempt organizations as he directed in his will. In the meantime the trustees were authorized to use the trust income in carrying on any trade or business, for speculative investments, etc., and all or a part of it might be lost and never go to any exempt organization. It is well settled that, when the trust instrument authorizes a use of the trust income which gives rise to a possibility that it will not go to an exempt organization, the income is not during the taxable years permanently set aside for payment to charity.

Taxpayer's miscellaneous contentions are without merit. This is not a case where the trust instrument simply permitted investment of income required to be permanently set aside for charity. Nor does Section 23 (o), allowing a different charitable deduction to individuals, have any bearing on an interpretation of Section 162 (a), which is stated to allow a charitable deduction to trusts in lieu of that allowed individuals under Section 23 (o). That business income is deductible under Section 162 (a) is no aid to taxpayer. The controlling fact is that no part of the trust income from any source was during the taxable years permanently set aside for payment to charity.

3. The filing of Forms 990 by taxpayer did not start the running of the three-year limitations period under Section 275 (a) for the assessment of income taxes so as to bar the deficiencies for 1943, 1944 and 1945. Section 302 (b) of the Revenue Act of 1950 provides when, for

years prior to 1951, Forms 990 will start the running of the limitations period. That statute excludes taxpayer's Forms 990.

The Forms 990 taxpayer filed for 1943, 1944 and 1945 were not returns required to be filed by Section 54 (f), let alone substitutes for income tax returns. Under Section 142 (a) and the pertinent Regulations, taxpayer was required to file fiduciary income tax returns on Form 1041 until it established to the satisfaction of the Commissioner that it was tax-exempt. The Regulations set forth the information required to establish a claim of exemption. Along with such information, the claimant is to file one Form 990 covering its business for the preceding year. In 1943, 1944 and 1945 taxpayer neither filed Forms 1041 nor claimed exemption. Had it claimed exemption beginning in 1943, it would only have been required by the Regulations to file a Form 990 for 1942, the year immediately preceding the taxable years. Taxpayer claimed exemption for the first time in 1946, when it filed Forms 990 for 1943, 1944 and 1945 along with an affidavit designed to establish exemption. Since it was denied exemption, the Forms 990 could not possibly constitute "returns" required to be filed by Section 54 (f), which requires annual information returns only of exempt organizations. Taxpayer is simply seeking to take advantage of its own disregard of Section 142 (a) and the Regulations.

Even if the Forms 990 had constituted returns required to be filed by Section 54 (f), they would not have been sufficient to start the running of the statute of limitations as to income taxes. They could not be considered as substitutes for income tax returns on Form 1041 unless they contained all the data necessary for the

computation and assessment of income taxes and furnished that information with the uniformity, completeness and arrangement of an income tax return. They did not do so.

ARGUMENT

I

The Trust Was Not "Organized and Operated Exclusively for * * * Charitable * * * Purposes" Within the Meaning of Section 101(6) of the Internal Revenue Code and Therefore Is Not Exempt from Tax

A. *Preliminary*

For the John Danz Charitable Trust to be exempt from tax under Section 101 (6) of the Internal Revenue Code (Appendix, *infra*) not only must no part of its net earnings inure to the benefit of any private individual but it must be a foundation "organized and operated exclusively for * * * charitable * * * purposes". It meets the requirement that no part of its net earnings inure to any private individual, because the trust fund is payable only to exempt organizations, but it is simply by reason of that fact that the trust contends that it meets the additional requirement that it be "organized and operated exclusively for * * * charitable * * * purposes".

The trust was not created to carry on any functional charitable activity, did not do so, and was in no way related to any exempt organization which did. As the Tax Court found (R. 110), the trust was created on December 31, 1942, by John Danz and his wife "for the purpose of making and supplying money" to charitable organizations concerned with educating the people with respect to an acceptable common philosophy. Disposi-

tion of trust funds was not so limited, however. Trust funds could be paid to any exempt organization, and in such amounts as John Danz, one of the grantors, designated. Trust funds were in fact paid to a number of unrelated exempt organizations, including the Red Cross, March of Dimes, American Cancer Society, and Boys' Town. (See R. 39, 76-77.) The trustees were given broad powers over the trust property, including the power to carry on any trade or business on behalf of the trust estate and to use funds or property of the trust estate in such trade or business. The trust did in fact engage in business, the operation of the Savoy Hotel and three candy stores. Its sole claim to exempt status under Section 101 (6) is that during the lifetime of John Danz trust funds are to be paid only to such exempt organizations as he designates and at his death the remainder is to be paid to such exempt organizations as he designates in his will.

The case thus presents for decision the question whether the trust is exempt from tax under Section 101 (6) *solely* by reason of the ultimate destination of its profits and property. In *Squire* v. *Students Book Corp.*, 191 F. 2d 1018, 1020, this Court stated that it had "itself made no definite pronouncement on the subject". In that decision the Court also stated that most of the courts confronted with the problem "appear" to have applied the " 'ultimate destination' test" (p. 1020) and taxpayer assumes that there is a "long line of cases supporting" the view that exemption under Section 101 (6) "is determined by the destination of the income" (Br. 21). Actually, that is not true, as we shall show. Even *Roche's Beach, Inc.* v. *Commissioner,* 96 F. 2d 776 (C.A. 2d), the supposed originator of the ultimate desti-

nation theory, is distinguishable from the instant case. *United States* v. *Community Services,* 189 F. 2d 421 (C.A. 4th), certiorari denied, 342 U. S. 932, and *Mabee Petroleum Corp.* v. *United States* (C.A. 5th), decided April 17, 1953 (1953 P-H, par. 72,474), are directly contrary to any idea that the ultimate destination of income is the *sole* test of exemption under Section 101 (6). Even this Court's own decision in *Bear Gulch Water Co.* v. *Commissioner,* 116 F. 2d 975, certiorari denied, 314 U. S. 652, is inconsistent with any such idea.

B. *Ultimate destination of income has not been established or even generally accepted by the courts as the sole test of exemption*

It was only in the recent cases of *C. F. Mueller Co.* v. *Commissioner,* 190 F. 2d 120 (C.A. 3d), and *Sico Co.* v. *United States,* 102 F. Supp. 197 (C. Cls.) (which are contrary to *United States* v. *Community Services, supra,* and inconsistent with *Mabee Petroleum Corp.* v. *United States, supra*) that ultimate destination of income was applied as the *sole* test of exemption under Section 101 (6). Ironically, those decisions applied that test under the mistaken notion that it was, as the Third Circuit called it in *Mueller* (p. 121), "established rationale".

To apply ultimate destination of income as the *sole* test of exemption under Section 101 (6) means that (1) an organization is considered to have a charitable purpose even though it does not itself carry on any functional charitable activity and is not even related to an organization which does and (2) that such an organization may be considered to be operated "exclusively" for charitable purposes even though it carries on a trade or

business for profit.[4] Most of the decisions cited in *Mueller* for such an "established rationale" do not in fact support it. *Trinidad* v. *Sagrada Orden,* 263 U. S. 578, the leading case, held that an organization which was *itself* engaged in carrying on religious, charitable and educational activities was "operated exclusively" for those purposes even though it received negligible profits from transactions in wine, chocolate and other articles which, instead of having financial gain as their end and amounting to a trade or business, were merely incidental to the organization's religious, charitable and educational activities. Four of the other cases cited in *Mueller* were also cases in which the taxpayer-organization was *itself* engaged in a functional charitable activity. *Debs Memorial Radio Fund* v. *Commissioner,* 148 F. 2d 948 (C.A. 2d); *Bohemian Gymnastic Ass'n Sokol of City of N.Y.* v. *Higgins,* 147 F. 2d 774 (C.A. 2d); *Commissioner* v. *Orton,* 173 F. 2d 483 (C.A. 6th); *Commissioner* v. *Battle Creek,* 126 F. 2d 405 (C.A. 5th). In all of those cases except *Debs Memorial Radio Fund* the taxpayer's commercial activity was incidental to its charitable activity, as in *Trinidad.* In *Debs Memorial Radio Fund* the commercial activity, consisting of accepting radio advertising, was not merely incidental to the taxpayer's charitable activity but on the other hand was related to it and was necessary. *Universal Oil Products Co.* v. *Campbell,* 181 F. 2d 451 (C.A. 7th), certiorari denied, 340 U. S. 850, also cited in *Mueller,*

---

[4] For convenience, throughout this brief we shall refer to Section 101(6) as relating only to charitable organizations. The section of course covers organizations organized and operated for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

opposes rather than supports the theory that ultimate destination of income is alone controlling.[5]

There are really only four decisions (*Roche's Beach, Inc.* v. *Commissioner, supra; Willingham* v. *Home Oil Mill,* 181 F. 2d 9 (C.A. 5th), certiorari denied, 340 U. S. 852; *C. F. Mueller Co.* v. *Commissioner, supra; Sico Co.* v. *United States, supra*) which even appear to accord exemption to an organization *solely* because of the ultimate destination of its income. As will be shown shortly, *Roche's Beach* and *Home Oil Mill* do not actually do so.

All four decisions misinterpret and misapply *Trinidad* v. *Sagrada Orden, supra,* and are essentially in conflict with this Court's decision in *Bear Gulch Water Co.* v. *Commissioner, supra,* and with the following: *Stanford University Book Store* v. *Helvering,* 83 F. 2d 710 (C.A. D.C.); *Universal Oil Products Co.* v. *Campbell, supra; United States* v. *Community Services, supra;* cf. *Gagne* v. *Hanover Water Works Co.,* 92 F. 2d 659 (C.A. 1st). The four decisions are also in conflict with decisions holding that even an organization which itself carries on a charitable activity is not exempt if it has an additional purpose which is not charitable. See, e.g., *Better Business Bureau* v. *United States,* 326 U. S. 279; *Smyth* v. *California State Automobile Ass'n,* 175 F. 2d 752 (C.A. 9th), certiorari denied, 338 U. S. 905; *Chattanooga Auto. Club* v. *Commissioner,* 182 F. 2d 551 (C.A. 6th). As the Fourth Circuit recognized in *Community Services* (p. 428), a great number of cases can be cited in which both the decisions

---

[5] *Mueller* also cited old Tax Court decisions in support of the "established rationale". Actually, as the Tax Court stated in the present case (R. 119-120), it has in recent years adhered to the opposite view.

and views expressed are so varied and divergent as to be irreconcilable.

C. *Even Roche's Beach and Home Oil Mill did not accord exemption solely on the basis of ultimate destination of income; neither decision supports exemption of a trust which, in addition to not carrying on any functional charitable activity itself, is in no way related to any exempt organization*

Roche's Beach is the forerunner of and supposed authority for *Home Oil Mill, Mueller* and *Sico Co.* Actually, *Roche's Beach* and *Home Oil Mill* are distinguishable from *Mueller* and *Sico Co.*

In *Roche's Beach* (in which Judge Learned Hand dissented) the corporation held to be exempt was one which the court stated (p. 776)—

> was organized by Edward Roche shortly before his death for the purpose of being the medium through which a charitable foundation created by his will [and holding all of the stock of the corporation] could operate his property and collect the income therefrom after his death. * * *

The court's conclusion that "As a question of fact, it seems clear that the corporation was organized and operated exclusively for charitable purposes" was based on three facts—that the proceeds from the corporation's activities were turned over to the charitable foundation established by Roche's will, that (p. 778)—

> The Board made a finding that Roche organized the corporation for the purpose of being the medium through which this foundation could operate the property and collect income after his death. * * *

and that Roche's will referred to the corporation and made manifest that the income produced by the corporation could not be used for other than charitable purposes without a perversion of the testamentary trust. The court stated that a corporation "organized and operated exclusively for * * * charitable * * * purposes" does not mean that to come within the exemption a corporation may not conduct business activities for profit and that "The destination of the income is more significant than its source." (P. 778.) The court then went on to hold that the exemption should not be denied the corporation merely because it did not itself perform a charitable function. In *Home Oil Mill,* where the stock of the taxpayer-corporation was bequeathed to a charitable trust and the corporation was stated to have been reorganized to exist solely and exclusively for religious, charitable and educational purposes, the Fifth Circuit recognized what *Roche's Beach* had really held. The court there stated that (p. 10)—

> If it is possible for a religious, charitable, and educational trust to operate an industry through a corporate agency, and be exempt under Section 101 (6) of Title 26 U.S.C.A., the appellant is entitled to such exemption.

and, on the authority of *Roche's Beach* and *Trinidad* v. *Sagrada Orden, supra,* held the corporation to be exempt.[6] In the very recent case of *Mabe Petroleum Corp.* v. *United States,* decided April 17, 1953 (1953 P.H., par. 72,473), the Fifth Circuit, which decided *Home Oil Mill, denied* exemption to a corporation whose profits were

---

[6] The decision was also placed on the ground of equitable estoppel.

all payable to a charitable foundation and whose stock was even owned by the charitable foundation.

Neither *Roche's Beach nor Home Oil Mill* stated that the corporation involved was "organized and operated exclusively" for charitable purposes simply because its income was payable to an exempt organization. In fact, in *Roche's Beach* the Second Circuit stated that "The destination of income is more significant than its source" (p. 778), rather than that the destination of income is conclusive as to the right to exemption. That the Fifth Circuit does not regard its *Home Oil Mill* decision as authority for the proposition that the charitable destination of income is sufficient of itself to support exemption is evident from its recent *Mabee Petroleum Corp.* decision, in which the court relied upon this Court's *Bear Gulch Water Co.* decision and *Universal Oil Products Corp.* v. *Campbell, supra.* The decisions in both *Roche's Beach* and *Home Oil Mill* obviously resulted in large part from the fact that in each instance the corporation involved, although a separate entity, was intended to be and was an operating medium for an exempt organization which owned all its stock. What the courts there really did was to consider a charitable trust and its operating medium as one, attributing to the operating medium the functional charitable purposes of the exempt charitable trust. This Court apparently did the same thing in *Squire* v. *Students Book Corp., supra,* where there was some factual basis for doing so.

Conversely, exemption has been denied because of the lack of such a relationship. *Stanford University Book Store* v. *Helvering, supra,* involved a cooperative association organized for the purpose of carrying on a gen-

eral mercantile business for the accommodation of the students and faculty of Leland Stanford Junior University. The Court of Appeals for the District of Columbia there stated (p. 712):

> We think that the record conclusively shows that the association is not "a corporation organized and operated exclusively for educational purposes." It must be remembered that the association is not, in contemplation of law, a division or part of the university. The university as such does not own any interest in the association, is not responsible for its debts, is not entitled to any part of its earnings, and takes no part in conducting and managing its affairs. The two institutions are separate legal entities and *therefore the attributes of the university cannot be attributed to the association,* nor can the latter claim to be an educational institution * * *. * * *(Italics supplied.)

In the present case (as was also true in *Mueller* and *Sico Co.*) there is no basis for attributing functional charitable purposes to the trust. There is no relationship between the trust and any exempt organization or between the trust's activities and those of any exempt organization. All we have is a trust whose profits and property are ultimately to be contributed to such charities as John Danz, one of the grantors, may designate. No specific charitable organization has a right to receive any portion of the trust fund at any time; the trust's contributions to exempt organizations, to be made at John Danz's direction, are not even limited to any particular type of exempt organization. *Roche's Beach* and *Home Oil Mill* do not support exemption

in such a case. Here, as the Fourth Circuit stated in *Community Services* (p. 425):

> For tax-exemption purposes, the charitable nature of the distributees of its income cannot be attributable to the taxpayer. * * *

D. *Exemption must be denied in a case where, as here, no functional charitable activity can even be attributed to the trust*

Mueller and *Sico Co.* are the only decisions (so far as we are aware) which hold an organization to be exempt from tax solely because of the ultimate destination of its profits.[7] In neither of those cases, unlike *Roche's Beach* and *Home Oil Mill,* was the organization involved an operating medium of an exempt organization through stock ownership or otherwise (although *Mueller* was later to become one), and there was thus no basis for attributing functional charitable activities to the organization. A functional charitable activity is a condition to exemption under Section 101 (6), as we shall now show. The statute does not exempt an organization, like the instant trust, to which functional charitable activities cannot even be attributed.[8]

1. Section 101 (6) provides three general conditions to exemption. Two of them are that the organization be "organized and operated exclusively for * * * charitable * * * purposes" (which can be broken down into two requirements, organization and operation for charitable purposes (*Universal Oil Products Co.* v.

[7] The Government's failure to petition for a writ of certiorari in those cases should not be taken as indicating approval of the decisions.

[8] So far as the instant case is concerned, it is academic whether or not it is proper to ignore the separate entity of an operating medium of an exempt corporation and attribute to it the functional charitable activities of the exempt organization.

Campbell, supra, p. 457) and that "no part of the net earnings of which inures to the benefit of any private shareholder or individual". The instant trust fulfills the second requirement, since its profits may be paid only to exempt organizations. But it is on the basis of that fact alone—the fulfillment of the second requirement—that the trust is claiming exemption. Obviously, it must also meet the first requirement and certainly Congress did not intend that requirement to be meaningless, as being fulfilled by meeting the second requirement. The first requirement—that the organization be "organized and operated exclusively for * * * charitable * * * purposes"—is clearly a *functional* requirement. *United States* v. *Community Services, supra; Bear Gulch Water Co.* v. *Commissioner, supra; Universal Oil Products Co.* v. *Campbell, supra;* cf. *Gagne* v. *Hanover Water Works, supra; Sun-Herald Corp.* v. *Duggan,* 160 F. 2d 475 (C.A. 2d). As stated in *Community Services* (p. 425)—

> The corporation earning the income and claiming the exemption, rather than the recipients of the income, must be organized and operated exclusively for charitable purposes.

2. Such a construction of Section 101 (6) is confirmed by subdivision (14) of Section 101 (Appendix, *infra*). In that subdivision Congress addressed itself to situations in which a corporation, which does not itself qualify for exemption under subdivision (6) or one of the other subdivisions of that section, dedicates its income to another organization which does qualify. Section 101 (14) exempts from tax the following:

> Corporations organized for the exclusive purpose of holding title to property, collecting income there-

> from, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this chapter; * * *

Thus, Congress was fully aware of the possibility that the net earnings of an organization which is not itself organized and operated exclusively for exempt purposes might be destined for other organizations which were so organized and operated, such as an exempt church or university. Yet it saw fit to limit the exemption in such cases to corporations and only to those whose function was that of "holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses", to exempt organizations. When Section 101 (14) is read together with Section 101 (6), as it must be (*Better Business Bureau* v. *United States, supra; Keystone Automobile Club* v. *Commissioner,* 181 F. 2d 402 (C.A. 3d)), it is manifest that Congress intended to accord tax exempt status to an organization on the basis of its own purposes and activities, not those of the recipients of its income, except in one type of situation—where a corporation serves merely as a holding and collecting medium for exempt organizations.

As the Fourth Circuit stated in *Community Services* (p. 425):

> Had Congress intended to accord tax exempt status to a corporation, regardless of the nature of its own activities, solely because its profits are distributed to exempt organizations, it would have been an easy matter to say this, simply and clearly.

Instead, in Section 101 (14) Congress carefully circumscribed the exemption of distributing organizations by

exempting only corporations whose exclusive purpose is of "holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses" to exempt organizations.

To construe Section 101 (6) as exempting any organization whose income is destined for exempt organizations is to render meaningless the express limitations contained in Section 101 (14). Unless the requirements of Section 101 (14) are to be discarded as sheer surplusage, the conclusion is inescapable that organizations engaged in ordinary business activities are not entitled to exemption under Section 101 (6) merely because their profits inure to the benefit of exempt organizations. See *Bear Gulch Water Co.* v. *Commissioner,* 116 F. 2d 975 (C.A. 9th), certiorari denied, 314 U. S. 652; *Gagne* v. *Hanover Water Works Co.,* 92 F. 2d 659 (C.A. 1st); and *Universal Oil Products Co.* v. *Campbell,* 181 F. 2d 451 (C.A. 7th), certiorari denied, 340 U.S. 850. As Judge Learned Hand stated in his dissenting opinion in *Roche's Beach* (p. 779)—

> It is possible that, if subdivision 14 had not been added to section 103, 26 U.S.C.A., § 103 (14) and note, we ought to have read subdivision 6, 26 U.S.C.A. § 103 (6) note, to comprise companies all of whose profits go to one of the purposes therein described, although *Trinidad* v. *Sagrada Orden,* 263 U.S. 578, * * * gives no color to such an interpretation; rather the reverse, for the business income of the taxpayer was there very trifling. * * * But subdivision 14 precludes any such reading. Obviously, as to all other subdivisions it meant that a subsidiary should not be exempted merely because its parent was exempt; that was indeed one condition, but the subsidiary must also confine its activi-

> ties to the mere receipt of income. * * * The purpose of subdivision 14 was to tax all business income, however, destined, unless the company was really not in business at all. * * *

It should particularly be noted that the meaning of subdivision (14)—that "a *subsidiary* should not be exempted merely because its *parent* was exempt" (italics supplied)—goes even further than is required in the present case, where we have no subsidiary and parent, and that Judge Hand was interpreting the majority decision in *Roche's Beach* for what it was—a holding that a subsidiary was exempt because its parent was exempt.

3. That Congress did not intend to accord tax exemption to a trust merely because its income is ultimately destined for exempt organizations is confirmed by Code Section 162 (a) (Appendix, *infra*), which in the taxable years provided in pertinent part as follows:

> SEC. 162. NET INCOME.
>
> The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that—
>
> (a) There shall be allowed as a deduction (in lieu of the deduction for charitable, etc., contributions authorized by section 23 (o)) any part of the gross income, without limitation, which pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in section 23 (o), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals. * * *

In allowing the deduction "without limitation" as to income which, pursuant to the deed or will creating the trust, is actually paid or permanently set aside in the taxable year for charity, Congress recognized that the entire income of a trust may be destined for charity. Nevertheless, it provided for a deduction, rather than exemption, by reason of the destination of the trust income and even limited the deduction. The grant of the right to take a deduction and the imposition of a restriction on the deduction are obviously inconsistent with any idea that a trust is altogether exempt from tax simply because its income is ultimately destined for charitable organizations.

The exemption accorded by Section 101 (6) also of course covers corporations which fulfill the necessary requirements. In the case of corporations, charitable deductions are limited by Code Section 23(q)(2) to an amount not exceeding five per cent of net income.[9] That section too is inconsistent with any idea that Section 101 (6) exempts from tax the entire net income of an organization simply because the income is ultimately destined for charitable organizations.

4. The legislative intent with respect to Section 101 (6) was affirmatively reflected in 1935 when the lan-

---

[9] Section 23(q), as amended by Section 125 of the Revenue Act of 1942, c. 619, 56 Stat. 798, permits a corporation to deduct, to an extent not exceeding five per cent of its net income—

> contributions or gifts payment of which is made within the taxable year to or for the use of:
>
> * * * * *
>
> (2) A corporation, trust, or community chest, fund or foundation * * * organized and operated exclusively for religious, charitable, scientific, literary, or education purposes * * * no part of the net earnings of which inures to the benefit of any private shareholder or individual * * *. * * *

guage of Section 101 (6) was adopted in Section 811 (b)(8) of the Social Security Act, c. 531, 49 Stat. 620. The Committee Reports accompanying that Act state (H. Rep. No. 615, 74th Cong., 1st Sess., p. 33 (1939-2 Cum. Bull. 600, 607; S. Rep. No. 628, 74th Cong., 1st Sess., p. 54 (1939-2 Cum. Bull. 611, 621)):

> The organizations which will be exempt from such taxes are churches, schools, colleges, and other educational institutions not operated for private profit, the Y.M.C.A., the Y.W.C.A., the Y.M.H.A., the Salvation Army, and other organizations which are exempt from income tax under Section 101 (6) of the Revenue Act of 1932.

5. As we shall show, provisions added by the Revenue Act of 1950, c. 994, 64 Stat. 906, clearly reflect the Congressional intent and understanding that Section 101 (6) does not exempt an organization to which a functional charitable activity cannot even be attributed. Taxpayer does not deny that subsequent legislation may be considered to aid in the interpretation of prior legislation (see *Great Northern Ry. Co.* v. *United States,* 315 U. S. 262, 277; *Brewster* v. *Gage,* 280 U. S. 327, 337) and, in fact, attempts to turn the 1950 Act to its own advantage (Br. 28-32).

As taxpayer states (Br. 29), by Section 301 (a) of the 1950 Act (Appendix, *Infra*) Congress amended Section 421 of the Code to tax the "unrelated business income" of *exempt* organizations. The "unrelated business net income" of an *exempt* organization is defined in Section 422 (a) (added by Section 301 (a) of the 1950 Act) as the gross income derived by an organization from any "unrelated trade or business (as defined in subsection (b))" regularly carried on

by it, less deductions and with certain exceptions, additions and limitations. The term "unrelated trade or business" is defined in subsection (b) as—

> any trade or business the conduct of which is not substantially related (*aside from* the need of such organization for income or funds or *the use it makes of the profits derived*) to the exercise or performance by such organization *of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 101,* * * * (Italics supplied.)

Thus, by Section 301 of the 1950 Act an exempt organization is taxable on income from a trade or business which is not substantially related to the exercise or performance of the charitable "purpose or function constituting the basis for its exemption under section 101" and that quoted language does not include "the use it makes of the profits derived". This unmistakably shows that Congress intended and understood that exemption under Section 101 rests upon a functional charitable activity. That intent and understanding must be applied to Section 101 (6) which, as taxpayer states (Br. 29), "was not changed by the 1950 Act".

Section 301 (b) of the 1950 Act (Appendix, *infra*) added the following paragraph at the end of Section 101 of the Code:

> An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall

not include the rental by an organization of its real property (including personal property leased with the real property).

This is further indication of the Congressional intent to preclude exemption of organizations not engaged in a functional charitable activity. Taxpayer, however, seeks to take advantage of the fact that this provision covers only organizations operated for the "primary" purpose of carrying on a trade or business. (Br. 28-32.) The provision is specifically applicable only to such organizations, but no conclusion can be drawn in taxpayer's favor from use of the word "primary". H. Rep. No. 2319, 81st Cong., 2d Sess., pp. 41-42, 124 (1950-2 Cum. Bull. 380, 412, 469) states:

> Section 301 (b) of your committee's bill provides that no organization operated primarily for the purpose of carrying on a trade or business (other than the rental of real estate) for profit shall be exempted under section 101 merely on the grounds that all of its profits are payable to one or more organizations exempt from tax under this section. * * *
>
> The effect of this amendment is to prevent the exemption of a trade or business organization under section 101 on the grounds that an organization actually described in section 101 receives the earnings from the operations of the trade or business organization. *In any case it appears clear to your committee that such an organization is not itself carrying out an exempt purpose.* * * * (Italics supplied.)

Moreover, no distinction can be drawn for years prior to 1951 on the basis of Section 301 (b) of the 1950 Act,

for Section 303 of the 1950 Act (Appendix, *infra*) provides that—

> The determination as to whether an organization is exempt under section 101 of the Internal Revenue Code from taxation for any taxable year beginning before January 1, 1951, shall be made as if section 301 (b) of this Act had not been enacted and *without inferences drawn from the fact that the amendment made by such section is not expressly made applicable with respect to taxable years beginning before January 1, 1951.* (Italics supplied.)

Taxpayer ignores the basic requirement for exemption, arguing (Br. 29-30) that, because of the addition of the above paragraph at the end of Section 101 and the provisions taxing the "unrelated business net income" of exempt organizations, Congress must have understood the language of Section 101 (6) to include organizations which have business income but are not operated for the *primary* purpose of conducting a trade or business. Such an argument is directed merely to the *extent* of business income and assumes that exemption may rest on the destination of business profits, whereas Congress has clearly reflected its intent and understanding that exemption under Section 101 is accorded only to organizations which engage in a functional charitable activity. As we shall show later, there is no basis for taxpayer's assertions as to the Congressional understanding even as related to organizations which *are* engaged in functional charitable activities.

6. It is no argument to say, as the Third Circuit did in *Mueller*, that Section 101 (6) must be given a liberal interpretation. Such an argument begs the issue by as-

suming that an organization which does not engage in a functional charitable activity is nevertheless a "charitable" organization within the meaning of the statute. It is a familiar rule of construction that tax exemptions are matters of legislative grace and are therefore to be strictly construed against the taxpayer. *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, 49; *Helvering* v. *Ohio Leather Co.*, 317 U. S. 102, 106. In any event, general rules of construction, while sometimes helpful in resolving ambiguities, cannot serve to defeat the plainly expressed legislative intent even where charitable or educational institutions are involved. *United States* v. *Community Services, supra; Universal Oil Products Co.* v. *Campbell, supra; Scholarship Endowment Foundation* v. *Nicholas*, 106 F. 2d 552 (C.A. 10th), certiorari denied, 308 U. S. 623. As the Supreme Court stated in *Better Business Bureau* (p. 283)—

> Even the most liberal of constructions does not mean that statutory words and phrases are to be given unusual or tortured meanings unjustified by legislative intent or that express limitations on such an exemption are to be ignored. * * *

E. *Assuming arguendo that a trust may be organized and operated for charitable purposes within the meaning of Section 101 (6) even though no functional charitable activity can be attributed to it, exemption must still be denied the instant trust because it was not operated "exclusively" for charitable purposes*

If we assume arguendo that a charitable purpose under Section 101 (6) need not be a functional charitable activity, the instant trust may be regarded as hav-

ing a charitable purpose—the donation of its profits and property to such exempt organizations as John Danz designates. However, the trust's primary purpose was to make money for contribution to exempt organizations. Viewing its purposes most liberally, here, as in *Community Services, supra* (p. 424)—

> Taxpayer was, in effect, organized and operated for two purposes: (1) to engage in commercial business, for profit, and (2) to turn over the profits realized from its commercial activities to charitable organizations. The second purpose is charitable; the first purpose clearly is not. * * *

Taxpayer's argument that it is nevertheless organized and operated "exclusively" for charitable purposes consists of an attempt to distinguish *Community Services* (Br. 22-32) on the ground that it involved an organization whose *primary* purpose was the operation of business enterprises. In that connection, taxpayer relies upon an interpretation of the 1950 Act which, as we shall show, is without basis. Presumably, taxpayer also relies upon *Roche's Beach, Home Oil Mill, Mueller* and *Sico Co.*, which in effect hold that an organization is organized and operated "exclusively" for charitable purposes even though one of its purposes or its sole purpose is to carry on a trade or business for profit. In that respect those decisions are clearly incorrect.

1. The 1950 Act not only refutes taxpayer's argument that *Community Services* is distinguishable on the ground that it involved an organization whose *primary* purpose was the operation of business enterprises, but supports the view that business activity unrelated to a functional charitable activity precludes exemption for years prior to 1951. As already shown, the specific

provision added by Section 301 (b) of the 1950 Act against exemption of an organization whose *primary* purpose is to carry on a trade or business for profit was added on the theory that such an organization is "not itself carrying out an exempt purpose". (H. Rep. No. 2319, *supra.*) In any case in which that is true, as here and in *Community Services* exemption must be denied.

But, in addition, the 1950 Act clearly shows that, for years prior to 1951, the effect of business activity (even as to an organization engaged in a functional charitable activity) depends upon the nature, rather than the extent, of the trade or business in which the organization engages. Section 302 (a) of the 1950 Act (Appendix, *infra*) provided as follows:

> SEC. 302. EXEMPTION OF CERTAIN ORGANIZATIONS FOR PAST YEARS.
>
> (a) *Trade or Business Not Unrelated—For any taxable year beginning prior to January 1, 1951,* no organization shall be denied exemption under paragraph * * * (6) * * * of section 101 of the Internal Revenue Code on the grounds that it is carrying on a trade or business for profit if the income from such trade or business would not be taxable as unrelated business income under the provisions of Supplement U of the Internal Revenue Code, as amended by this Act, or if such trade or business is the rental by such organization of its real property (including personal property leased with the real property). (Italics supplied.)

As we have already shown, "unrelated business income" means income from a trade or business which is not substantially related to the exercise or perform-

ance by an organization "of its charitable, educational, or other purpose or function constituting the basis of its exemption under section 101" *excluding* the destination of profits. (Section 301 (a) of the 1950 Act.) In taxing such income of *exempt* organizations, the 1950 Act treats an organization as exempt even though it has unrelated business income (provided it engages in a functional charitable activity to give it a basis for exemption), but we are here concerned with years prior to 1951. As to such years, Section 302 (a) of the 1950 Act has the effect of providing that an organization is not to be denied exemption if its business income is substantially related to the exercise or performance of its functional charitable activity or activities. The plain inference is that an organization which has business income which is *not* related to a functional charitable activity of the organization must be *denied* exemption for years prior to 1951. It is the nature, not the extent, of the business activity, which is material.

2. To the extent they hold that an organization may be exempt despite the receipt of unrelated business income, *Roche's Beach, Home Oil Mill, Mueller* and *Sico Co.* are contrary to several Court of Appeals decisions, including this Court's decision in *Bear Gulch Water Co.* v. *Commissioner, supra.* In that case the taxpayer-corporation was one whose stock was all owned by the regents of the University of California and, accordingly, its income and property had an exempt corporation as their ultimate destination but the taxpayer-corporation was not itself engaged in a functional charitable activity. This Court affirmed the Tax Court's decision that the corporation was not exempt under Section 101 (6) because its "business was a business enterprise conducted for gain". (P. 977.) In

Community Services the Fourth Circuit denied exemption to a corporation whose charter stated that it was designed to conduct businesses in order to earn profits to be devoted exclusively to religious, charitable, scientific, literary and/or educational purposes. In *Universal Oil Products Corp.* v. *Campbell, supra,* the Seventh Circuit denied exemption to a corporation which was primarily (but not solely) a research organization and whose stock and income notes were held by an exempt trust whose beneficiary was the American Chemical Society, also admittedly tax-exempt. Cf. *Stanford University Book Store* v. *Helvering,* 83 F. 2d 710 (C. A. D. C.), where the Court of Appeals for the District of Columbia denied exemption to a cooperative association organized for the purpose of carrying on a general mercantile business for the accommodation of the students and faculty of Leland Stanford Junior University.

3. *Roche's Beach ,Home Oil Mill, Mueller* and *Sico Co.* are contrary to the decisions of the Supreme Court in *Better Business Bureau* v. *United States,* 326 U. S. 279, and *Trinidad* v. *Sagrada Orden, supra.* Those decisions show that even an organization which is itself engaged in functional charitable activities is not exempt if it has a single, substantial non-charitable purpose.

In *Better Business Bureau* the Supreme Court denied exemption to a corporation whose charter stated that it was organized for the purpose of promoting better business ethics among merchants in the community and of educating the public regarding deceptive business practices, and its activities were directed towards those ends. The corporation had no stock and it was stipulated that no part of its earnings inured to

the benefit of any private shareholder or individual. Among other things, the Supreme Court there stated (p. 283):

> In this instance, in order to fall within the claimed exemption, an organization must be devoted to educational purposes exclusively. *This plainly means that the presence of a single noneducational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes.* * * * (Italics supplied.)

The *Trinidad* case involved a corporation which carried on religious, charitable and educational work with income consisting of rents, dividends, interest and negligible profits from transactions in wine, chocolate and other articles. The Government conceded both that the corporation was organized and operated for religious, charitable and educational purposes and that no part of its net income inured to the benefit of any stockholder or individual. The Government contended, however, that the corporation was not "operated exclusively" for religious, charitable and educational purposes because of the trading in wine, chocolate and other articles. In deciding the case in favor of exemption, the Supreme Court first noted that, in making its property productive by way of rents, dividends, and interest and applying such income to religious, charitable and educational purposes, the corporation was adhering to and advancing those purposes. With respect to the questioned activity—the transactions in wine, chocolate and other articles—the Court stated (p. 582):

> * * * we think they do not amount to engaging in trade in any proper sense of the term. It is not

> claimed that there is any selling to the public or in competition with others. The articles are merely bought and supplied for use within the plaintiff's own organization and agencies,—some of them for strictly religious use and the others for uses which are purely incidental to the work which the plaintiff is carrying on. That the transactions yield some profit is in the circumstances a negligible factor. Financial gain is not the end to which they are directed.

What *Trinidad* holds, therefore, is that a corporation which is organized to and does carry on functional charitable activities is "operated exclusively" for charitable purposes despite (1) the receipt of investment income and (2) the receipt of profits from transactions which, instead of having financial gain as their end and amounting to engaging in trade or business, are incidental to the charitable work in which the corporation is engaged. The necessary implication of the decision is that even a corporation engaged in functional charitable activities is not "operated exclusively" for charitable purposes if it engages in other activities which, instead of being incidental to the charitable activity, are conducted for financial gain and amount to engaging in a trade or business for profit. That is precisely what Congress intended and understood the rule to be, for, as we have already shown, the 1950 Act unmistakably reflected the Congressional intent and understanding that, for years prior to 1951, an exempt organization is one which has no business income *unrelated to its functional charitable activities.*

Trinidad did state at one point that the statute makes the destination of income the ultimate test of exemption (p. 581), but, as stated by the Seventh Circuit in

Universal Oil Products Co. v. *Campbell, supra* (p. 458)—

> We must bear in mind, however, that there the Court was only considering whether an inconsequential portion of the income of the taxpayer derived from sales to its own members and agencies prevented it from being operated *exclusively* for charitable and educational purposes. The primary purpose of the organization and operation of the taxpayer was not in question.

Any possible doubt as to the proper interpretation of *Trinidad* has been removed by the statement of the Supreme Court in *Better Business Bureau* (p. 283) that "the presence of a single noneducational purpose, *if substantial in nature,* will destroy the exemption". (Italics supplied.) There is now no possible excuse for following *Roche's Beach.* The Third Circuit and Court of Claims erred in doing so in *Mueller* and *Sico Co.,* respectively.[10]

---

[10] The *Mueller* decision reflects error and confusion on practically every point discussed, but the court's fundamental error was in believing that a large number of cases, all with readily distinguishable facts, stood for the same proposition. That error appears not only from the court's citation of cases in support of the so-called "established rationale", already discussed, but from its criticism (190 F. 2d, p. 122, fn. 8) of *Community Services* as following—

> the dissenting opinion of Judge Learned Hand in *Roche's Beach* * * *, albeit Judge Hand agreed with *Bohemian Gymnastic Ass'n Sokol* v. *Higgins,* 1945, 147 F. 2d 774, and *Consumer-Farmer Milk Coop., Inc.* v. *Commissioner,* 2 Cir., 1950, 186 F. 2d 68, certiorari denied 1951, 71 S. Ct. 803, both of which follow the majority in the *Roche's Beach* case.

The latter two decisions can hardly be said to have followed the majority in *Roche's Beach* and certainly Judge Learned Hand's concurrence in those decisions does not reflect any change in his early position. The business carried on in *Bohemian Gymnastic Ass'n Sokol of City of N. Y.* v. *Higgins, supra,* was incidental to the functional educational activities of the organization involved, as in

4. If the Congressional intent were not so clearly reflected in the 1950 Act for years prior to 1951, it would be pertinent to take cognizance of the *implied* Congressional intent reflected in long-standing Treasury Regulations and the reenactment of Section 101 (6). *Commissioner* v. *Flowers,* 326 U. S. 465, 469; *Boehm* v. *Commissioner,* 326 U. S. 287; *Helvering* v. *Winmill,* 305 U. S. 79. Section 29.101(6)-1 of Treasury Regulations 111 (Appendix, *infra*) is derived from and is substantially the same as Article 517 of Treasury Regulations 65, promulgated under the Revenue Act of 1924. It provides that to qualify for exemption a corporation must be "organized and operated exclusively for one or more of the specified purposes" and that a religious organization "which also manufactures and sells articles to the public for profit" is not exempt even though its profits do not inure to private shareholders or individuals. Thus, the long-standing Treasury Regulations, which have the force and effect of law (*Better Business Bureau, supra,* p. 286) except to the extent, if any, they have been modified by the 1950 Act for

---

Trinidad. In *Consumer-Farmer Milk Coop.* v. *Commissioner,* 186 F. 2d 68 (C.A. 2d), certiorari denied, 341 U.S. 931, which involved the subdivision granting exemption to civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, exemption was *denied* a cooperative non-stock corporation on the ground that it was organized for profit as well as for the promotion of social welfare. Strangely, in that decision the Second Circuit stated, among other things, that (p. 71)—

> To qualify for exemption, *profit derived from commercial activities must not only be incidental to the ultimate charitable purpose;* it must also be devoted to that purpose. * * * (Italics supplied.)

The italicized portion of the statement, if accepted at face value, accepts our interpretation of *Trinidad*, as well as the Congressional intent and understanding as evidenced by the 1950 Act, and is inconsistent with the majority decision in *Roche's Beach.*

years prior to 1951, precluded exemption if the organization was engaged in a trade or business for profit.

II

No Part of the Trust Net Income Was, Pursuant to the Trust Instrument, Permanently Set Aside During the Taxable Years for Charitable Purposes so as to Be Deductible Under Section 162(a) of the Code

The full amounts actually paid by the trust to charitable organizations during the taxable years (pursuant to John Danz's direction) were allowed as deductions under Section 162 (a) of the Code in the agreed computation for entry of decision by the Tax Court, but taxpayer contends that its remaining net income of the taxable years is also deductible under Section 162 (a) of the Code.[11] (Br. 32-59.) That section provides as follows:

> (a) There shall be allowed as a deduction (in lieu of the deduction for charitable, etc., contributions authorized by section 23 (o)) any part of the gross income, without limitation, which pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in section 23 (o), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit;

---

[11] The contributions actually paid to charitable organizations during the taxable years (see R. 39, 76-77) were treated by the Commissioner as having been paid from income although they were listed (R. 39, 76) as having been paid from corpus.

The contention that this statute covers the instant trust income of the taxable years is premised simply upon the fact that the trust instrument provides for a remainder gift, at John Danz's death, to such charities as he designates in his will. As the Tax Court held (R. 123-125), Section 162 (a) does not entitle taxpayer to any deduction in addition to the amounts actually paid to charitable organizations during the taxable years.

As taxpayer concedes (Br. 46, 49, 50), the second clause of Section 162 (a), relating to income "to be used exclusively for * * * charitable * * * purposes", adds nothing to the first clause except to make it clear that a deduction is allowed for income held for *direct* charitable use by the estate or trust itself.[12] The first clause is broad enough to cover such a situation, as taxpayer also admits (Br. 49), and we are not in any event concerned here with any such situation. The instant trust instrument did not require, direct or authorize the trust to engage in any functional charitable activity.

The inquiry on this branch of the case, therefore, is simply whether the trust net income of each taxable year not paid to charitable organizations was "during the taxable year * * * permanently set aside" for payment to exempt organizations "pursuant to the terms of the * * * deed creating the trust". Treasury Regulations 111, Section 29.162-1 (Appendix, *infra*). It plainly was not.

First of all, it should be noted that the trustees, who apparently had discretion under the trust instrument

---

[12] Taxpayer's long explanation (Br. 53-55) of *Estate of Whitehead* v. *Commissioner*, 3 T.C. 40, affirmed *sub nom. Commissioner* v. *Citizens & So. Nat. Bank*, 147 F. 2d 977 (C.A. 5th), seems directed primarily to establishing this point.

to do so, did not in fact "permanently set aside" any of the trust income of any taxable year for payment to charitable organizations.[13] The trust income not actually paid to charitable organizations during the taxable years was obviously used by the trustees, for the trust borrowed money from John Danz and Sterling Theaters, Inc., and in all of the taxable years was indebted on such loans. (R. 115.) In any event, there is nothing in the record to show a permanent setting aside of trust income by the trustees during any taxable year.

Recognizing that the trustees did not in fact "permanently set aside" any part of the trust income during any taxable year, taxpayer relies upon decisions in which it was held that no action on the part of the trustees was required—that the income involved was permanently set aside for charitable purposes by the trust or will itself. (Br. 45.) Those decisions hold that of the trust instrument or decedent's will unequivocably requires the payment of the income involved to certain charitable organizations or if the possibility of payment to others is so remote as to be negligible, such income is "permanently set aside" for charitable purposes by the trust instrument or will itself and a crediting of such income to the charities by the trustees is unnecessary. See *Bowers* v. *Slocum*, 20 F. 2d 350 (C.A. 2d); *Hopkins* v. *Commissioner*, 13 T. C. 952; *Slocum* v. *Commissioner*, 6 B. T. A. 36; *Johnson* v. *Commissioner*, 13 B. T. A. 850; *McClung* v. *Commissioner*, 13 B. T. A.

---

[13] It appears that income is "permanently set aside" for charitable purposes pursuant to the trust instrument if the trust instrument gives the trustees discretion to permanently set aside income for charitable purposes and they do in fact do so. See *Old Colony Co.* v. *Commissioner*, 301 U. S. 379.

335; *Welch* v. *Commissioner,* 9 B. T. A. 1370; *Irving Bank-Columbia Trust Co.* v. *Commissioner,* 8 B. T. A. 833; *Beggs* v. *United States,* 27 F. Supp. 599, 607 (C. Cls.). For example, in *Bowers* v. *Slocum, supra,* income received during the course of administration of an estate was held to have been permanently set aside for charitable purposes because the income was a part of the decedent's residuary estate and the decedent's will required payment of the residuary estate to certain charitable organizations.[14]

The present case is not one in which the trust instrument itself permanently set aside trust income during

---

[14] *Commissioner* v. *Citizens & So. Nat. Bank, supra,* which taxpayer relies upon in connection with the *second* clause of Section 162(a), already discussed, and takes more than four pages of its brief to explain (Br. 50-55), was an application of *Bowers* v. *Slocum, supra.* In that case the testator had in 1935 left his entire estate to a corporation to be formed for the purpose of using the income for charitable and educational purposes, both directly and by payments to other organizations, subject to the payment of specified annuities to two individuals and to directions for carrying out settlement contracts which the decedent had entered into with a former wife and with his wife. The will specifically directed that the *income* be used for payment of the specific bequests and for the charitable purposes of the corporation. The corporation was not formed until 1937 and in the meantime the executor used income for the payments of the specified annuities, settlement payments to the decedent's former wife and wife, and for a compromise settlement of a suit by the wife. It was held that the entire income received during the course of administration, except for the annuities payable out of income, was deductible under Section 162(a). That holding was based on conclusions that the corporation to be formed and to receive the decedent's estate was a charitable trust, despite the fact that the property it was to receive was charged with small bequests, and that the income received during the taxable years by the executor and to be paid to the charitable trust (except for the amount of the annuities) was permanently set aside for the corporation by the will even though it was temporarily diverted by the executor to defray corpus charges. In brief, all that the case stands for, so far as pertinent here, is that income which the will *requires* to be paid to a charitable trust is permanently set aside for charitable purposes despite its temporary use by the executor for another purpose, the will being controlling over the action of the executor.

the taxable years. The instrument simply gave John Danz "the right during his lifetime and by his Last Will and Testament, to designate" charitable beneficiaries (R. 28-29) and provided (R. 29):

> Trustees shall distribute to the beneficiary or beneficiaries so named such amounts of the corpus and income of Trust A [the instant trust] and at such time or times as shall be specified from time to time by John Danz in writing to Trustees. Upon the death of John Danz any amounts remaining in Trust A shall be distributed to beneficiaries (qualified as hereinafter set forth) as directed by John Danz, either in writing to the Trustees or in his Last Will and Testament. * * *

Thus, the only trust income which the trust instrument required to be paid to charitable organizations was that which John Danz, in his discretion, directed to be paid to charities from time to time (for which deductions have been allowed for the taxable years) and whatever income as such remained at John Danz's death. Up to the time of John Danz's death, the trust funds not directed by him to be paid to charitable organizations could be used by the trustees in carrying on any trade or business, "whether or not speculative and wheresoever located"; for investments in property, "whether or not speculative in character"; to purchase property (R. 25); to rent or repair property of the trust estate; for loans "with or without security"; for investment or speculation, or loans to, any enterprise in which the trustees are personally interested (R. 26); and for advances to the other trusts created by John Danz and his wife (R. 28). The trustees were authorized, "In investing or speculating with trust funds", to combine

funds of the taxpayer trust with funds of the other trusts (R. 26) and in making investments the trustees (R. 26-27)—

> shall in no way be limited to investments commonly referred to as legal for trust funds but shall use the funds of the trust estates in such manner as in their sole discretion they shall deem for the best interests of these trusts and the beneficiaries thereof.
>
> Any speculations or investments made by and any business enterprises carried on by trustees on behalf of the trust estates, shall be entirely at the risk of the trust estates and trustees, in the absence of bad faith, shall in no way be personally liable for indebtedness, liabilities or losses incurred therein. This shall apply even though the speculation, investment or enterprise is one in which trustees are personally interested.

Thus, instead of requiring the trust income of any given year to be "permanently set aside" for charitable organizations, the trust instrument authorized its use for other purposes, even speculative in nature. As the Tax Court stated (R. 124), "The income of a particular year used for such purposes might never go to any charity". Current trust income could be put to various uses of the trust and "never reach any charity as income or principal, for example, it might be lost in the business venture". (R. 125.) There may conceivably be trust income as such which will be paid to charitable organizations at John Danz's death, but that will not be because the trust instrument required trust income to be "permanently set aside" during the taxable years, as required for deduction under Section 162 (a).

Deduction under Section 162 (a) is not authorized simply because trust income remaining at the end of a specified time is payable to charitable organizations. The deduction is for income which "is during the taxable year * * * permanently set aside" for charitable purposes and trust income is not "during the taxable year * * * permanently set aside" for charitable purposes if it is subject to some other use or if the trustees have an option as to its use, as this Court held in *Bank of America Nat. T. & Sav. Ass'n* v. *Commissioner,* 126 F. 2d 48, and in *Maloney* v. *Glover,* 171 F. 2d 870, certiorari denied, 337 U. S. 917. See, also, *Boston Safe Deposit & T. Co.* v. *Commissioner,* 66 F. 2d 179 (C.A. 1st), certiorari denied, 290 U.S. 700.

To argue the contrary, as taxpayer does, is to argue that income of the taxable years is deductible under Section 162(a) in any case in which there is a remainder gift to charity. The Supreme Court flatly rejected such a contention in *Merchants Bank* v. *Commissioner,* 320 U. S. 256, 263, because "of the explicit requirement that the income be permanently set aside". In that case, where the remainders were to certain named charities, deduction under Section 162(a) was denied on the ground that the ultimate destination of the trust income was uncertain because of the possibility of invasion for use of the life beneficiary. See also *Langenbach's Estate* v. *Commissioner,* 134 F. 2d 590 (C.A. 6th); *Commissioner* v. *Upjohn's Estate,* 124 F. 2d 73, 76 (C.A. 6th); *Charles P. Moorman Home for Women* v. *United States,* 42 F. 2d 257 (W.D. Ky.).

Taxpayer may attempt to distinguish the above cases on the ground that they involved situations where there was an option to use, or possibility of use of, trust in-

come for payment to non-charitable *beneficiaries,* whereas in the present case trust income may not be paid to any non-charitable beneficiary. But the specific reason why charity may not receive the trust income is immaterial. So long as the trust income may be lost to charity, it cannot be considered income which "is during the taxable year * * * permanently set aside" for payment to charitable organizations.

Such amounts should be readily susceptible of proof and, as this Court held in *Bank of America Nat. T. & Sav. Ass'n* v. *Commissioner, supra,* the taxpayer has the burden of proving what part of the trust income of the taxable years will go to charity. Mere speculation is insufficient. *Merchants Bank* v. *Commissioner, supra.* The fact that it is impossible for taxpayer to sustain that burden of proof shows that no part of the trust income was permanently set aside for charity during the taxable years.

While perhaps not of great significance in the circumstances of this case, no *specific* exempt organization had a right to receive any part of the trust income or corpus, either immediately or ultimately. Cf. *Huesman's Estate* v. *Commissioner,* 198 F. 2d 133 (C.A. 9th). The beneficiaries of the trust were not named in the trust instrument; they were to be such as John Danz designated. Up to the time of his death, when he was to designate exempt organization to take the remaining trust fund, no beneficiary existed which had any interest in the trust fund or right to sue for mismanagement or enforcement of the trust.

Taxpayer attempts to avoid the force of the requirement of Section 162 (a) that the income be "during the taxable year * * * permanently set aside" by arguing

that it is immaterial that the trustees had authority to invest the trust income. (Br. 41-43.) The authorities relied upon are informal rulings which do not even commit the Commissioner to an interpretation of the law (*Helvering* v. *N. Y. Trust Co.*, 292 U.S. 455) and which involved situations in which taxpayer assumes the power to invest income existed.[15] Assuming that the mere power to invest income pending the distribution thereof to charities required by the trust instrument does not preclude a deduction under Section 162 (a), the instant case is one in which the trust instrument authorized more than mere investment of income set aside for charity. The trust instrument not only authorized repeated changes in the use of the income but specifically authorized use of the income for *speculative* investments and for carrying on active trades and businesses with all their attendant risks. It is frivolous for taxpayer to contend, as it does in effect, that income is "during the taxable year * * * permanently set aside" for payment to charity even though it is subject to risk of loss in the active conduct of any trade or business in which the trustees may choose to venture. Unless the trustees actually do permanently set aside trust income for payment to charity, income will be "permanently set aside" for charity pursuant to the trust instrument only at John Danz's death and then only in the amount remaining. For income to be deductible under Section 162(a), it must be permanently set aside for charity "during the taxable year".

---

[15] At another point taxpayer states that the power of investment was involved in *Hopkins* v. *Commissioner*, 13 T.C. 952, in which the Tax Court allowed a deduction under Section 162(a) without any discussion of the use of income in making investments. (Br. 55.) It is a sufficient answer to that decision that the instant decision, with different facts, was also decided by the Tax Court.

There is no merit in taxpayer's argument (Br. 35-40) that its income should be held to be deductible under Section 162 (a) because individuals are allowed a deduction under Section 23 (o) (Appendix, *infra*) for payments to taxpayer. The deduction for trusts under Section 162 (a) is stated to be in lieu of the deduction authorized by Section 23 (o) for individuals and, as a comparison of the two statutes reveals, is not the same as the latter. *Frank Trust of 1931* v. *Commissioner,* 145 F. 2d 411, 413 (C.A. 3d). Obviously, Section 162 (a) cannot be interpreted in conjunction with a statute for which it is a substitute. Section 162 (a) must be given effect according to its plain language, as this Court in effect held in *Huesman's Estate* v. *Commissioner, supra.*

Taxpayer is in error in arguing (Br. 58-59) that its construction of Section 162 (a) is confirmed by changes made by the 1950 Act. In line with the amendments made by the 1950 Act with respect to exempt organizations, Congress, by Section 321 (a) and (b) of the 1950 Act (Appendix, *infra*), made Section 162 (a) subject to exceptions contained in a new subsection (g) which, among other things, precluded the deduction under Section 162 (a) of any *business* income of a trust.[16] Taxpayer conceives that to be a recognition that a deduction under Section 162 (a) could be taken for years prior to 1950 even if the income came from the operation of a business. (Br. 58-59.) It was unnecessary for taxpayer to rely upon the 1950 Act for such a con-

[16] In terms the added provisions preclude the deduction of what would be the trust's "unrelated business net income" if it were exempt from tax but, as stated in H. Rep. No. 2319, 81st Cong., 2d Sess., p. 43 (1950-2 Cum. Bull. 380, 413)—

> In the case of trusts under section 162, however, no trade or business may be considered "related". * * *

clusion. For years prior to 1950 there is no restriction under Section 162 (a) in respect of the *nature* of trust income. Whether from business or investment, income is deductible if it is "during the taxable year paid or permanently set aside" for payment to charitable organizations. The disallowance by the 1950 Act of any charitable deduction in respect of business income for subsequent years is of no materiality here. Nor is it of any significance that, as taxpayer points out (Br. 59), H. Rep. No. 2319, *supra,* stated that a trust which either "distributes or accumulates" its income for charitable purposes is, for all practical purposes, exempt from income taxes. So far as shown, the instant trust has not accumulated trust income.

III

The Filing of Form 990 Returns Required of Exempt Organizations under Section 54(f) of the Code Did Not Start the Running of the Three-Year Limitations Period Prescribed by Section 275(a) for Assessment of Taxes so as to Bar Collection of the Deficiencies for 1943, 1944 and 1945

Since taxpayer is not exempt from tax under Section 101 (6), it was required by Section 142 (a) of the Code (Appendix, *infra*) to file fiduciary income tax returns for the taxable years on Form 1041. For the years 1943, 1944 and 1945 it filed such returns on July 28, 1947. (R. 84.) The deficiencies for those years were assessed by the Commissioner on October 14, 1949 (R. 85), which was within the three-year limitations period for assessment prescribed by Section 275 (a) of the Code (Appendix, *infra*).[17] Taxpayer contends, however, that the deficiencies for 1943, 1944 and 1945 are barred on the ground that as to those years the three-

[17] Section 275(a) provides that assessment of tax shall be made "within three years after the return was filed".

year limitation period started running on September 18, 1946, when it filed Form 990 information returns required of *exempt* organizations under Section 54 (f) of the Code and Treasury Regulations 111, Section 29.101-1 (Appendix, *infra*). As the Tax Court held (R. 126-128), the contention has no merit.

In the 1950 Act Congress itself specifically provided when, *for prior years,* the filing of a Form 990 information return required by Section 54 (f) shall constitute the filing of a return for the purposes of Section 275 (a). Section 302 (b) of the 1950 Act (Appendix, *infra*) provides:

> (b) *Period of Limitations.*—In the case of an organization which would otherwise be exempt under section 101 of the Internal Revenue Code were it not carrying on a trade or business for profit, the filing of the information return required by section 54 (f) of the Internal Revenue Code (relating to returns by tax-exempt organizations) *for any taxable year beginning prior to January 1, 1951,* shall be deemed to be the filing of a return for the purposes of section 275 of the Internal Revenue Code (relating to period of limitation upon assessment and collection). * * * The provisions of this subsection shall not apply to a taxable year of such an organization with respect to which, prior to September 20, 1950, (1) any amount of tax was assessed or paid, or (2) a notice of deficiency under section 272 of the Internal Revenue Code was sent to the taxpayer. (Italics supplied.)

Taxpayer's Form 990 returns for the years 1943, 1944 and 1945 are thus *not* to be treated as returns for the purpose of Section 275(a), for two reasons. First, a notice of deficiency for those years was sent to tax-

payer prior to September 20, 1950. Secondly, taxpayer is not an organization which would otherwise be exempt under Section 101 were it not carrying on a trade or business for profit. As we showed in Point I, *supra,* by Section 301 of the 1950 Act Congress made unmistakably clear its understanding and intent that exemption under Section 101 (6) rests upon a *functional charitable activity.* As we also showed previously, no functional charitable activity can even be attributed to taxpayer, through relationship to an exempt organization or otherwise.

Even if Section 302 (b) of the 1950 Act had not been enacted and settled the matter, taxpayer's Form 990 would not have constituted returns for limitations purposes under Section 275 (a), for two reasons. In the first place, the Forms 990 did not, at the time they were filed, constitute "returns" required to be filed by *any* statute. Secondly, they did not contain all the data from which income tax could be computed and assessed.

Section 54 (f) of the Code requires an annual *information* return only of *exempt* organizations. Treasury Regulations 111, Section 29.101-1, provide that every organization claiming exemption, with exceptions not pertinent here, must establish its exemption by furnishing information on a certain questionnaire and submitting certain pertinent documents, and shall also file "a return of information on Form 990 relative to the business of the organization for the last complete year of operation". The Regulations further provide that—

> *When an organization* (other than a mutual insurance company) *has established its right to exemption, it need not thereafter make a return of*

> *income* or any further showing with respect to its status under the law, unless * * *, except that every organization exempt or claiming exemption under section 101 (5), (6), except * * *, shall file annually returns of information on Form 990 * * *. * * * (Italics supplied.)

Thus an organization is not relieved of filing income tax returns until it establishes its claimed right to exemption. Annual information returns on Form 990 are required only of exempt organizations. If an organization establishes its right to exemption, it is required to file Form 990; if it does not establish its right to exemption, it must continue filing Form 1041. While the Regulations require the premature filing of one Form 990, the form becomes a "return" required by Section 54 (f) only if the organization establishes its right to exemption. When, as here, the Form 990 is not a "return" required to be filed by Section 54 (f), having been filed by an organization which did not establish exemption, it certainly cannot be a substitute for the return required of taxpayer by Section 142 (a) nor a return for the purpose of starting the running of the statute of limitations for assessment of income taxes.[18]

---

[18] That is the reason the "unpublished ruling" to which taxpayer refers (Br. 65) was not applied in taxpayer's case. The unpublished ruling, which of course is without force and effect in any event, was merely an informal memorandum written by an employee of the Bureau of Internal Revenue in which he expressed the opinion that the Commissioner would be justified in treating a Form 990 as a return sufficient to start the running of the statute of limitations for assessment of income taxes *if the forms furnished sufficient data for computation of income tax and depending upon the provisions and circumstances under which the returns were required and upon the basis of the facts involved in each case.* For a time the Bureau treated the Forms 990 as sufficient to start the running of the statute of limitations *when filed by organizations determined by*

It should especially be noted that this is not a case of a taxpayer mistakenly filing a wrong form, but a case in which the taxpayer is seeking to take advantage of its own disregard of the statute and Regulations. Taxpayer had income in 1943, 1944 and 1945 which it was required by Section 142 (a) of the Code to return on Form 1041 unless it claimed and established exempt status. Taxpayer not only did not file such returns but it did not claim or attempt to establish exempt status until September 19, 1946. (R. 83.) Then, instead of filing, along with the information required by the Regulations of a taxpayer claiming exemption, "a" return "of information" on Form 990 "relative to the business of the organization for the last complete year of operation", as required by the Regulation, it filed a Form 990 for all three previous years. Since taxpayer did not even claim exemption during 1943, 1944 and 1945, there is no possible excuse for its failure to file Forms 1041 for those years, as required by Section 142 (a) of the Code. And, moreover, had it claimed exemption beginning in 1943, it would have been required by the Regulations to file only one information Form 990 and that for the year *1942*.

At this point, *Commissioner* v. *Lane-Wells Co.,* 321 U.S. 219, is pertinent. In that case the taxpayer was required by pertinent Treasury Regulations to file two separate returns, an income tax return and a personal holding company tax return, and failed to file the personal holding company return. The Supreme Court

---

the Commissioner to be exempt, which may or may not have been proper. However, the records of the Bureau disclose *no* case in which a Form 990 was treated as starting the running of the statute of limitations when filed by an organization which never established a tax-exempt status or was denied exemption.

held that the filing of the income tax return did *not* start the running of the statute of limitations as to the personal holding company taxes. Decision was based on a conclusion that the Treasury Regulations requiring two separate returns for the two types of taxes was reasonable and valid. Among other things, the Supreme Court stated (p. 223):

> Congress has given discretion to the Commissioner to prescribe by regulation forms of returns and has made it the duty of the taxpayer to comply. * * * The purpose is not alone to get tax information in some form but also to get it with such uniformity, completeness, and arrangement that the physical task of handling and verifying returns may be readily accomplished. * * *

In the present case only the income tax is involved, but the Regulations clearly show (1) that taxpayer was not relieved of filing *income tax* returns unless and until it claimed and established that it was tax-exempt and (2) that the Forms 990 filed by taxpayer were not even "returns" required by Section 54 (f), let alone Section 142 (a).

Even if the Forms 990 filed by taxpayer for 1943, 1944 and 1945 had been "returns" required to be filed by Section 54 (f) or the Regulations, they would not have been sufficient as *income tax* returns to start the running of the statute of limitations under Section 275 (a) for assessment of income taxes. *Germantown Trust Co.* v. *Commissioner,* 309 U. S. 304, relied upon by taxpayer (Br. 63-64), shows that one type of return may be a substitute for another type of return only when it contains all the data from which the tax can be com-

puted and assessed.[19] Such data must be supplied, not just "in some form", but with "such uniformity, completeness, and arrangement" that the physical task of handling and verifying returns may be readily accomplished. *Commissioner* v. *Lane-Wells Co., supra,* p. 223. Taxpayer is incorrect in asserting (Br. 64) that its Forms 990 for 1943, 1944 and 1945 "disclosed all the data from which the tax could be computed". Not only were the Forms 990 mere "information" returns "relative to the business of the organization" (Treasury Regulations 111, Section 29.101-1), the filing of which constituted a *denial* of tax liability, but, as the Tax Court stated (R. 127)—

> The stipulation includes copies of the returns filed. A comparison of those returns [Form 990] with the fiduciary returns [Form 1041] for those same years filed on July 29, 1947 shows that they do not contain all of the data from which a tax could be computed and assessed. * * * Furthermore, the information was not only not in the form required of taxpayers, but it was not given with such uniformity, completeness, and arrangement as to constitute an adequate return for the purpose of starting the running of the statute of limitations on assessment and collection of the taxes due. *Commissioner* v. *Lane-Wells Company,* 321 U.S. 219, * * *. * * *

For a comparision of the two types of returns filed for 1943, 1944 and 1945, see Joint Exhibits 2B, 3C, 4D

[19] It should perhaps be noted that in the *Germantown Trust Co.* case, where the question was whether the fiduciary return filed by the taxpayer was sufficient to start the running of the statute of limitations despite the Commissioner's contention that the taxpayer should have filed a corporate return, it was conceded that the taxpayer was a fiduciary as to a certain fund and that the fiduciary return was one which the taxpayer "was bound to file." (P. 308.)

(Forms 990) and 6F, 7G, 8H (Forms 1041), all transmitted to this Court in their original form.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

H. Brian Holland,
Assistant Attorney General.
Ellis N. Slack,
Melva M. Graney,
Special Assistants to the Attorney General.

May, 1953.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(o) [as amended by Sec. 224 (a) of the Revenue Act of 1939, c. 247, 53 Stat. 862, and Sec. 127 (c) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Charitable and Other Contributions.*—In the case of an individual, contributions or gifts payment of which is made within the taxable year to or for the use of:

(1) The United States, any State, Territory, or any political subdivision thereof or the District of Columbia, or any possession of the United States, for exclusively public purposes;

(2) A corporation, trust, or community chest, fund, or foundation, created or organized in the United States or in any possession thereof or under the law of the United States or of any State or Territory or of any possession of the United States, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation;

(3) the special fund for vocational rehabilitation authorized by section 12 of the World War

Veteran's Act, 1924, 43 Stat. 611 (U.S.C., Title 38, § 440);

(4) posts or organizations of war veterans, or auxiliary units or societies of any such posts or organizations, if such posts, organizations, units, or societies are organized in the United States or any of its possessions, and if no part of their net earnings inures to the benefit of any private shareholder or individual; or

(5) a domestic fraternal society, order, or association, operating under the lodge system, but only if such contributions or gifts are to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals;

to an amount which in all the above cases combined does not exceed 15 per centum of the taxpayer's net income as computed without the benefit of this subsection or of subsection (x). Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner, with the approval of the Secretary.

For unlimited deduction if contributions and gifts exceed 90 per centum of the net income, see section 120.

* * * * *

(26 U.S.C. 1946 ed., Sec. 23.)

SEC. 54. RECORDS AND SPECIAL RETURNS.

* * * * *

(f) [as added by Sec. 117 (a) of the Revenue Act of 1943, c. 63, 58 Stat. 21] Every organization, except as hereinafter provided, exempt from taxa-

tion under section 101 shall file an annual return, which shall contain or be verified by a written declaration that it is made under the penalties of perjury, stating specifically the items of gross income, receipts, and disbursements, and such other information for the purpose of carrying out the provisions of this chapter as the Commissioner, with the approval of the Secretary, may by regulations prescribe, and shall keep such records, render under oath such statements, make such other returns, and comply with such rules and regulations as the Commissioner, with the approval of the Secretary, may from time to time prescribe. No such annual return need be filed under this subsection by any organization exempt from taxation under the provisions of section 101—

(1) which is a religious organization exempt under section 101 (6); or

(2) which is an educational organization exempt under section 101 (6), if such organization normally maintains a regular faculty and curriculum and normally has a regularly organized body of pupils or students in attendance at the place where its educational activities are regularly carried on; or

(3) which is a charitable organization, or an organization for the prevention of cruelty to children or animals, exempt under section 101 (6), if such organization is supported, in whole or in part, by funds contributed by the United States or any State or political subdivision thereof, or is primarily supported by contributions of the general public; or

(4) which is an organization exempt under section 101 (6), if such organization is operated, supervised, or controlled by or in connection with

a religious organization described in paragraph (1); or

(5) which is an organization exempt solely under section 101 (3); or

(6) which is an organization exempt under section 101 (15), if such organization is a corporation wholly owned by the United States or any agency or instrumentality thereof, or a wholly owned subsidiary of such a corporation.

(26 U.S.C. 1946 ed., Sec. 54.)

SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS.

The following organizations shall be exempt from taxation under this chapter—

* * * * *

(6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation;

* * * * *

(14) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this chapter;

* * * * *

(26 U.S.C. 1946 ed., Sec. 101.)

SEC. 142. FIDUCIARY RETURNS.

(a) [as amended by Sec. 112 (b) of the Revenue Act of 1941, c. 412, 55 Stat. 687, and Sec. 131 (c) (2) of the Revenue Act of 1942, *supra*] *Requirement of Return.*—Every fiduciary (except a receiver appointed by authority of law in possession of part only of the property of an individual) shall make under oath a return for any of the following individuals, estates, or trusts for which he acts, stating specifically the items of gross income thereof and the deductions and credits allowed under this chapter and such other information for the purpose of carrying out the provisions of this chapter as the Commissioner with the approval of the Secretary may by regulations prescribe—

(1) Every individual having a gross income for the taxable year of $500 or over, if single, or if married and not living with husband or wife;

(2) Every individual having a gross income for the taxable year of $1,200 or over, if married and living with husband or wife;

(3) Every estate the gross income of which for the taxable year is $500 or over;

(4) Every trust the net income of which for the taxable year is $100 or over, or the gross income of which for the taxable year is $500 or over, regardless of the amount of the net income; and

(5) Every estate or trust of which any beneficiary is a nonresident alien.

* * * * *

(26 U.S.C. 1946 ed., Sec. 142.)

SEC. 162. NET INCOME.

The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that—

(a) There shall be allowed as a deduction (in lieu of the deduction for charitable, etc., contributions authorized by section 23 (o)) any part of the gross income, without limitation, which pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in section 23 (o), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit;

* * * * *

(26 U.S.C. 1946 ed., Sec. 162.)

SEC. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

Except as provided in section 276—

(a) *General Rule.*—The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

* * * * *

(26 U.S.C. 1946 ed., Sec. 275.)

Revenue Act of 1950, c. 994, 64 Stat. 906:

SEC. 301. INCOME OF EDUCATIONAL, CHARITABLE, AND CERTAIN OTHER EXEMPT ORGANIZATIONS.

(a) *Tax on Certain Types of Income.*—Supplement U of chapter 1 is hereby amended to read as follows:

"SUPPLEMENT U—TAXATION OF BUSINESS INCOME OF CERTAIN SECTION 101 ORGANIZATIONS

"SEC. 421. IMPOSITION OF TAX.

(a) *In General.*—There shall be levied, collected, and paid for each taxable year beginning after December 31, 1950—

"(1) upon the supplement U net income (as defined in subsection (c)) of every organization described in subsection (b)(1), a normal tax of 25 per centum of the supplement U net income, and a surtax of 20 per centum of the amount of the supplement U net income in excess of $25,000.

"(2) upon the supplement U net income of every trust described in subsection (b)(2), a normal tax computed at the rate and in the manner provided in section 11 and a surtax computed at the rates and in the manner provided in section 12 (b). In making such computations for the purposes of this section, the term 'the amount of the net income in excess of the credits against net income provided in section 25' as used in section 11 shall be read as 'the amount of the supplement U net income' and the term 'surtax net income' as used in section 12 (b) shall be read as 'supplement U net income'.

"(b) *Organizations Subject to Tax.*—

"(1) *Organizations taxable as corporations.*—The taxes imposed by subsection (a) (1) shall apply in the case of any organization (other than a church, a convention or association of churches, or a trust described in paragraph (2)) which is exempt, except as provided in this supplement, from taxation under this chapter by reason of paragraph (1), (6), or (7) of section 101. Such taxes shall also apply in the case of a corporation described in section 101 (14) if the income is payable to an organization which itself is subject to the tax imposed by subsection (a) or to a church or to a convention or association of churches.

"(2) *Trusts taxable at individual rates.*—The taxes imposed by subsection (a)(2) shall apply in the case of any trust which is exempt, except as provided in this supplement, from taxation under this chapter by reason of paragraph (6) of section 101 and which, if it were not for such exemption, would be subject to the provisions of supplement E.

"(c) *Definition of Supplement U Net Income.*—The term 'supplement U net income' of an organization means the amount by which its unrelated business net income (as defined in section 422) exceeds $1,000.

* * * * *

"SEC. 422. UNRELATED BUSINESS NET INCOME.

"(a) *Definition.*—The term 'unrelated business net income' means the gross income derived by any organization from any unrelated trade or business (as defined in subsection (b)) regularly carried

on by it, less the deductions allowed by section 23 which are directly connected with the carrying on of such trade or business subject to the following exceptions, additions, and limitations:

* * * * *

"(b) *Unrelated Trade or Business.*—The term 'unrelated trade or business' means, in the case of any organization subject to the tax imposed by section 421 (a), any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 101, * * *

* * * * *

The term 'unrelated trade or business' means, in the case of a trust computing its unrelated business net income under this section for the purposes of section 162 (g)(1), any trade or business regularly carried on by such trust or by a partnership of which it is a member.

* * * * *

(b) *Feeder Organizations.*—Section 101 is hereby amended by adding at the end thereof the following paragraph:

"An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of

this paragraph the term 'trade or business' shall not include the rental by an organization of its real property (including personal property leased with the real property)."

* * * * *

(26 U.S.C. 1946 ed., Supp. IV, Secs. 101, 421-422.)

SEC. 302. EXEMPTION OF CERTAIN ORGANIZATIONS FOR PAST YEARS.

(a) *Trade or Business Not Unrelated.*—For any taxable year beginning prior to January 1, 1951, no organization shall be denied exemption under paragraph (1), (6), or (7) of section 101 of the Internal Revenue Code on the grounds that it is carrying on a trade or business for profit if the income from such trade or business would not be taxable as unrelated business income under the provisions of Supplement U of the Internal Revenue Code, as amended by this Act, or if such trade or business is the rental by such organization of its real property (including personal property leased with the real property.)

(b) *Period Limitations.*—In the case of an organization which would otherwise be exempt under section 101 of the Internal Revenue Code were it not carrying on a trade or business for profit, the filing of the information return required by section 54 (f) of the Internal Revenue Code (relating to returns by tax-exempt organizations) for any taxable year beginning prior to January 1, 1951, shall be deemed to be the filing of a return for the purposes of section 275 of the Internal Revenue Code (relating to period of limitation upon assessment and collection). In the case of such an organization which was, by the provisions of section 54 (f)

of the Internal Revenue Code, specifically not required to file such information return, for the purposes of the preceding sentence a return shall be deemed to have been filed at the time when such return should have been filed had it been so required. The provisions of this subsection shall not apply to a taxable year of such an organization with respect to which, prior to September 20, 1950, (1) any amount of tax was assessed or paid, or (2) a notice of deficiency under section 272 of the Internal Revenue Code was sent to the taxpayer.

* * * * *

SEC. 303. EFFECTIVE DATE OF PART I.

The amendments made by this part shall be applicable only with respect to taxable years beginning after December 31, 1950. The determination as to whether an organization is exempt under section 101 of the Internal Revenue Code from taxation for any taxable year beginning before January 1, 1951, shall be made as if section 301 (b) of this Act had not been enacted and without inferences drawn from the fact that the amendment made by such section is not expressly made applicable with respect to taxable years beginning before January 1, 1951.

SEC. 321. CHARITABLE, ETC., DEDUCTIONS OF TRUSTS.

(a) *Amendment of Section 162.*—Section 162 is hereby amended by adding at the end thereof the following:

"(g) *Rules for Application of Subsection (a) in the Case of Trusts.*—

"(1) *Trade or business income.*—In computing the deduction allowable under subsection (a)

to a trust for any taxable year beginning after December 31, 1950, no amount otherwise allowable under subsection (a) as a deduction shall be allowed as a deduction with respect to income of the taxable year which is allocable to its Supplement U business income for such year. As used in this paragraph the term 'Supplement U business income' means an amount equal to the amount which, if such trusts were exempt under section 101 (6) from taxation, would be computed as its unrelated business net income under section 422 (relating to income derived from certain business activities and from certain leases).

* * * * *

"(4) *Accumulated income.*—If the amounts permanently set aside, or to be used exclusively, for the charitable and other purposes described in subsection (a) during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year—

"(A) are unreasonable in amount or duration in order to carry out such purposes of the trust; or

"(B) are used to a substantial degree for purposes other than those described in subsection (a); or

"(C) are invested in such a manner as to jeopardize the interests of the religious, charitable, scientific, etc., beneficiaries,

the amount otherwise allowable under subsection (a) as a deduction shall be limited to the amount actually paid out during the taxable year and shall not exceed 15 per centum of the income of the trust (computed without the benefit of subsection (a))."

(b) *Technical Amendment.*—Section 162 (a) is hereby amended by striking out "There shall be allowed as a deduction" and inserting in lieu thereof "Subject to the provisions of subsection (g), there shall be allowed as a deduction".

(26 U.S.C. 1946 ed., Supp. IV, Sec. 162.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.101-1. *Proof of Exemption.*—A corporation is not exempt merely because it is not organized and operated for profit. In order to establish its exemption it is necessary that every organization claiming exemption file with the collector for the district in which is located the principal place of business or principal office of the organization an affidavit or a questionnaire as set forth below. An organization claiming exemption under section 101 (1), * * * (6), * * * shall file the form of questionnaire appropriate to its activities, filled out in accordance with the instructions on the form or issued therewith. Copies of the following questionnaire forms may be obtained from any collector: For corporations claiming exemption under section 101 (6), Form 1023 * * *. * * * To each such affidavit or questionnaire shall be attached a copy of the articles of incorporation, declaration of trust, or other instrument of similar import, setting forth the permitted powers or activities of the organization, the by-laws or other code of regulations, and the latest financial statement showing the assets, liabilities, receipts, and disbursements of the organization. An organization claiming exemption under section 101 (5), (6), except organizations organized and operated exclusively for religious purposes, (7), (8), (9), or (14) shall also

file with the other information specified herein a return of information on Form 990 relative to the business of the organization for the last complete year of operation; provided, however, that such return shall not be required of an organization which is organized and operated exclusively for educational purposes, or educational and religious purposes, if no part of its net earnings or assets are distributable to any private shareholder in liquidation or otherwise and if, in the case of an organization privately owned or operated, the Commissioner is advised of any increase in the compensation of its owners, managers, trustees, or directors over the amount of such compensation for the last year for which its exemption under section 101 (6) was approved by the Commissioner. Form 990 will not be required of charitable organizations operated or controlled by religious or educational organizations of the type exempt under the preceding sentence from the requirement of filing such returns, nor of separately conducted charitable organizations meeting the above conditions as to distributions and compensation, nor of charitable organizations operated under the control of a State or any political subdivision thereof.

* * * * *

The collector, upon receipt of the affidavit, or questionnaire, and other papers, will examine them as to completeness and will forward completed documents to the Commissioner for decision as to whether the organization is exempt. In addition to the information specified herein, the Commissioner may require any additional information deemed necessary for a proper determination of whether a particular organization is exempt under section 101, and when deemed advisable in the

interest of an efficient administration of the internal revenue laws he may in the cases of particular types of organizations provide additional questionnaires or otherwise prescribe the form in which the proof of exemption shall be furnished.

When an organization (other than a mutual insurance company) has established its right to exemption, it need not thereafter make a return of income or any further showing with respect to its status under the law, unless it changes the character of its organization or operations or the purpose for which it was originally created, except that every organization exempt or claiming exemption under section 101 (5), (6), except organizations organized and operated exclusively for religious purposes, (7), (8), (9), or (14) shall file annually returns of information on Form 990 with the collector for the district in which is located the principal place of business or principal office of the organization; provided, however, * * *. * * * The return of information on Form 990 shall be filed on or before the 15th day of the fifth month following the close of the taxable year. * * *

* * * * *

An organization which is exempt, under section 101 and the regulations thereunder, from filing returns of income is not, however, relieved from the duty of filing returns of information (see sections 147 and 148).

SEC. 29.101(6)-1. *Religious, Charitable, Scientific, Literary, and Educational Organizations and Community Chests.*—In order to be exempt under section 101(6), the organization must meet three tests:

(1) It must be organized and operated exclusively for one or more of the specified purposes;

(2) Its net income must not inure in whole or in part to the benefit of private shareholders or individuals; and

(3) It must not by any substantial part of its activities attempt to influence legislation by propaganda or otherwise.

* * * * *

Since a corporation to be exempt under section 101(6) must be organized and operated exclusively for one or more of the specified purposes, an organization which has certain religious purposes and which also manufactures and sells articles to the public for profit, is not exempt under section 101(6) even though its property is held in common and its profits do not inure to the benefit of individual members of the organization. See section 101(18) as to religious or apostolic associations or corporations.

A corporation otherwise exempt under section 101(6) does not lose its status as an exempt corporation by receiving income such as rent, dividends, and interest from investments, provided such income is devoted exclusively to one or more of the purposes specified in that section.

SEC. 29.162-1. *Income of Estates and Trusts.*—
* * *

From the gross income of the estate or trust there are also deductible (either in lieu of, or in addition to, the deductions referred to in the preceding paragraph of this section) the following:

(a) Any part of the gross income of the estate or trust for its taxable year which, by the terms

of the will or of the instrument creating the trust, is paid or permanently set aside during such year for the charitable, etc., uses or purposes referred to or described in section 162(a). This deduction is in lieu of that authorized by section 23(o) in the case of individual taxpayers.

* * * * *

☆ U. S. GOVERNMENT PRINTING OFFICE: 1953 253243 158